CASH ACCOUNTING: A SIMPLER METHOD FOR SMALL FIRMS?

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CASH ACCOUNTING: A SIMPLER METHOD FOR SMALL FIRMS?

THURSDAY, JULY 10, 2014

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON ECONOMIC GROWTH,
TAX AND CAPITAL ACCESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 2360, Rayburn House Office Building. Hon. Tom Rice [chairman of the subcommittee] presiding.

Present: Representatives Rice, Chabot, Mulvaney, Hanna, Schweikert, Chu, Paine, and Schneider.

Chairman RICE. Good morning. This hearing will come to order.

First, let me thank our witnesses for taking time to be with us today to talk about how to help small businesses prosper.

As a former tax attorney and CPA for nearly 30 years, I know firsthand that tax complexity is a big problem facing small business owners. Today, we are going to examine one way to simplify life for small firms by looking at the issue of the cash method of accounting, which offers a simple, straightforward solution for entrepreneurs to record business income and expenses. In cash accounting, a business records incoming expenses at the time the funds are received or paid, just like with a personal checkbook, and it makes it fairly easy to track cash flow, the lifeblood of many entrepreneurs. Perhaps because of this simplicity it is a preferred method of accounting for small businesses.

The other, more complicated method, accrual accounting, requires a business to record income at the time a sale is made or an agreement to provide services reached, regardless of when the payment is actually received. By the same token, expenses are recorded when they are obligated to be paid, regardless of when the funds were actually dispersed.

In determining which accounting method to use, small business owners must comply with the Internal Revenue code. Most businesses are required to use the accrual method, though exceptions exist which permit firms of certain types and sizes to use the cash method.

Ultimately, whichever method is used can have very real effects on how a small business operates. Given this, it would be in the interest of us here in Washington to ensure our nation's job creators have the flexibility to use the accounting method that best suits their operations and gives them the best chance to succeed.

We are fortunate to have with us a group of leaders within the accounting community, both industry experts and small businesses that help other small businesses with their accounting services. I look forward to learning firsthand how they perceive the utility of the cash accounting for small businesses and how we can make cash accounting even easier for small businesses to use.

With that, I would like to thank our distinguished panel of witnesses for being here today, and I now recognize the ranking member for her opening statement.

Ms. CHU. Thank you, Mr. Chair.

For many, starting a successful business and seeing it grow is the American dream. During that process, many big decisions must be made—where to rent, what to call the business, and how much capital is needed. Besides deciding which business organizational structure to adopt, one of the most basic decisions is which accounting method to use—accrual accounting or cash basis method. On the surface, the question may seem easy, but small business owners must learn several rules and complicated nuances associated with each technique. These methods primarily differ in when and how income and expenses are reported. The cash method accounting is widely used by small firms because it is simple to understand and makes day-to-day recordkeeping easier. It generally requires taxpayers to report income and expenses as they are received and paid, so it mimics how individuals handle their own personal finances. Simply put, income is reported when cash comes in, and expenses are reported when cash goes out.

On the other hand, the accrual accounting method generally requires taxpayers to report income and expenses as the transactions are established, regardless of whether cash is received or paid. While accrual accounting offers the flexibility to delay or advance income and expensing to more accurately reflect business operations. The cash method more accurately reflects cash flow.

Most small business owners track the profitability of their business during the year based on the balance in their checking account, which is more in line with the cash accounting, so it is not surprising that the National Federation of Independent Businesses found that 41 percent of small business owners utilize the cash method of accounting, while only 19 percent use the accrual method. I have also heard repeatedly from small business owners in my district how much they depend on the cash accounting method.

Today's hearing will examine the differences between the two accounting methods and discuss what makes the cash accounting method more advantageous for small business owners. We will also discuss the tax reform proposal for expanding the cash method revenue limit and the draft language limiting its use to certain organizational structures. The proposal was introduced earlier this Congress by Chairman Dave Camp of the Ways and Means Committee.

Reforms that lower the burden on small businesses by reducing recordkeeping and paperwork help to lead to increased entrepreneurial activity and a stronger economy. Under current law, C corporations and certain partnerships may not use the cash method once average gross receipts exceed five million. However, some partnerships and S corporations are permitted to use the cash method regardless of their level of receipts, provided they are not

required to maintain inventories. The draft proposal generated much debate surrounding the cash accounting method because it would expand and limit the availability of this critical accounting scheme.

Despite increasing its use to allow businesses with up to $10 million in gross receipts, the draft language prohibits S corporations and partnerships that previously qualified for the cash method from continuing to use it, and that means that personal service corporations, like businesses performing accounting, dentistry, and legal services would no longer qualify if they hit the gross receipts ceiling.

This raises many questions and concerns for those small businesses, and this hearing will highlight some of them. Providing relief for thousands of small firms is critical to moving forward with tax reform. However, we must be cautious as to how that simplicity is provided. Today's hearing presents the opportunity to have a real debate on the accounting methods used by millions of small business owners and how certain tax reform proposals can affect their bottom line.

I want to thank all the witnesses for being here, and I look forward to your testimony. Thank you, and I yield back.

Chairman RICE. Okay. Just some formalities to get out of the way.

If committee members have an opening statement, I ask that they submit it for the record.

I would like to take a moment to explain the timing lights for you. You will each have five minutes to deliver your testimony. The lights will start out as green. When you have one minute remaining, it will turn yellow. And finally, at the end of your five minutes, it will turn red. I will ask that you try to adhere to that time limit, although we are not going to be very strict.

Our first witness today is Professor Donald Williamson of the American University where he teaches and serves as the director of Masters of Science and Taxation Program. He is also the executive director of the Americans Kogod Tax Center. Prior to his time at American University, he served as senior manager for international taxation at KPMG. A certified public accountant, Mr. Williamson is a frequent lecturer to professional groups throughout the nation, and has published over 50 articles in professional and academic journals.

Thank you for being here, sir. We look forward to your testimony.

STATEMENTS OF DONALD WILLIAMSON, PROFESSOR, DEPARTMENT OF ACCOUNTING AND TAXATION AND EXECUTIVE DIRECTOR, KOGOD TAX CENTER, AMERICAN UNIVERSITY; SARAH WINDHAM, CERTIFIED PUBLIC ACCOUNTANT AND SENIOR TAX MANAGER, DIXON HUGHES GOODMAN, LLC; TERRY DURKIN, OWNER, DURKIN ASSOCIATES; STEPHEN MANKOWSKI, PARTNER, EP CAINE AND ASSOCIATES CPA, LLC

STATEMENT OF DONALD WILLIAMSON

Mr. WILLIAMSON. Thank you, Chairman Rice.

Chairman Rice, Ranking Member Chu, and members of the Subcommittee, thank you for the opportunity to testify on the need to simplify the tax reporting requirements on small businesses by means of adopting simpler methods of tax accounting, most notably, expanding the circumstances whereby small business may use the cash method rather than the more burdensome accrual method of accounting.

My name is Don Williamson, and I am a professor of Taxation at American University's Kogod School of Business, where for the past 30 years I have directed the school's Masters in Taxation degree program. The MST program at American offers graduate courses in federal taxation to CPAs, experienced accountants, attorneys, and others who wish to expand their knowledge of our nation's tax law. Our course offerings not only include traditional classes in subject areas such as taxation of corporations and partnerships, but also more specialized areas of the tax law, such as accounting periods and methods, which is the topic of this hearing today.

As part of my responsibilities at American, I am also the executive director of the Kogod Tax Center, which conducts nonpartisan research on tax issues affecting small business and entrepreneurs, and for the past 25 years, I have had my own tax preparation and tax planning practice for small businesses in Falls Church, Virginia.

My written testimony describes the key differences between the cash and accrual methods of account for the reporting of income and expenses on the tax return of a small business. For now, let me simply say that the accrual method is undeniably the more complex method of accounting and that it offers few advantages to small businesses whose chief concern with regard to their financial condition is their cash flow. It is important to note that the method of accounting adopted by a business, whether it be the cash method or the accrual method, only affects the timing of when a business reports income or deductions on its tax return. The accounting method a business uses does not determine whether an item of income is taxable or an expense deductible and does not affect the total income and deductions a business will recognize over its lifetime.

However, despite the greater simplicity and better fit of the cash method for small businesses, the Internal Revenue Code denies the cash method to corporations with average gross receipts exceeding $5 million. I urge Congress to increase the current threshold for use of the cash method to $10 million. Raising the threshold to $10 million will mean that almost 90 percent of all businesses in the United States could adopt the cash method of accounting.

But even when the cash method is available to small business, certain judicial doctrines, such as constructive receipt for the recognition of income impose unnecessary complication on a small business simply to accelerate the reporting of income by, in most cases, a few months before the actual cash is received. Also, the requirement that a cash method small business may not deduct its cash outlays to purchase inventory until that product is sold may satisfy accounting theorists but offers no immediate tax benefit to small businesses that expend considerable sums creating jobs. To

address these needs of small businesses, I urge Congress to go beyond simply expanding the number of small businesses eligible to use the cash method of accounting and consider enacting a simplified cash method of accounting along the lines described in my written testimony. Under this method of accounting, a small business would be able to look at its checkbook to determine its taxable income. It sounds simple, and it is. Permitting small business to elect a simplified cash method of accounting will reduce tax compliance costs, ease the burden of tax administration, and clarify the measurement of taxable income.

I thank the Committee again for the opportunity to testify. I welcome any questions you may have.

Chairman RICE. Thank you, sir.

Our next witness is Sarah Windham, certified public accountant and senior tax manager at Dixon Hughes Goodman in my home state in Charleston, South Carolina. Mrs. Windham has been in public practice for 15 years and has extensive experience preparing tax returns and consulting with small business clients, with particular expertise in the agriculture and construction industries. She is testifying today on behalf of the South Carolina Farm Bureau. We appreciate you being here. You may now begin your testimony.

STATEMENT OF SARAH WINDHAM

Ms. WINDHAM. Thank you. Chairman Rice and members of the Committee, thank you for allowing me the opportunity to testify today.

My name is Sarah Windham, and I am a senior tax manager in the Charleston, South Carolina office of Dixon Hughes Goodman. We are the largest CPA firm based in the southern U.S. Our commitment to our clients' success has led to the development of specialized practice groups, such as agribusiness. With nearly 60 years of experience serving the agribusiness industry, DHG has developed a deep understanding of the operations and issues affecting the agribusiness industry. I am a CPA with 15 years of experience. I have extensive experience with agriculture clients, construction and real estate clients, as well as many other small businesses. I am here today on behalf of South Carolina Farm Bureau.

I am testifying before you today on the potential negative ramifications of the various proposals in Congress that would eliminate for many taxpayers the use of cash accounting for the purpose of calculating income tax liability. These adverse effects include a significant increase in the time dedicated to tax compliance, which will defer farmers and other small businesses from focusing on making a living, as well as an increase in the cost of tax compliance that will reduce the profitability of many farms and small businesses who already work on very thin margins.

Another effect would be a significant acceleration of the tax liability without cash available to pay the uncollected, yet taxed income. These adverse effects would fall disproportionately on small businesses, such as farmers, and on professionals, such as those in my farm. Most farmers do not employ professional accountants. Many farms' books and records are maintained by family members or the farm owners themselves. Requiring them to switch to accrual basis accounting would force them to hire bookkeeping assist-

ance and/or spend additional funds on accrual accounting systems, thus creating additional costs in an industry that continues to face rapidly rising production expenses.

One story I would like to share with you reflects the strain accrual accounting can put on farms. One of our farm clients was being asked by his financial institution to provide accrual financial statements on a quarterly basis. As with most farms, they keep their books and records on the cash basis. After explaining the additional fees that a farmer would incur to have us assist their staff in converting the books to accrual basis, it was agreed that cash basis statements would be a better option.

Farmers, by nature, manage risk and volatility. They are literally at the mercy of nature, the effects and aftermath of weather, and commodity prices. Since their income can fluctuate wildly from year to year, accrual accounting, coupled with our progressive tax system, would likely cause farmers to pay more tax over time than a company in a different industry with stable income over the same time period. Cash accounting also allows them the option to even-out their taxable income comparable with long-term earnings with other industries. It gives them the ability to plan for capital investments and large purchase of inputs without incurring debt.

An independent research firm, Informa Economics, revealed that U.S. agriculture producers required to switch from cash to accrual basis under the proposed new laws could pay out as much as $4.84 billion in taxes over the next four years. According to this study, those same farms have only 1.4 billion in cash reserves to pay the additional taxes. If the tax proposals associated with accrual accounting are effective in an unprofitable year or farm owners cannot otherwise meet their capital requirements, the farm may be forced to downsize. Over 17 percent of the U.S. workforce is employed in the agriculture industry. The estimated 4.84 billion in tax that would be required to be paid by farmers may cause them not to hire additional employees or to lay off employees they already have due to downsizing.

We have many clients required to use accrual basis accounting for various reasons in the Internal Revenue Code. As I mentioned in my introduction, I have expertise in construction. Especially in today's economy, many contractors are experiencing the pains of collecting receivables and managing cash flow. Contractors may not receive payment until well after they have invoiced their customers and recorded income under accrual accounting. Oftentimes, they may be filing their tax return well before those receivables have been collected.

In a recent experience I had with a contractor I have been working with, he was faced with extending his tax return several years in a row in order to collect the revenue that he needed from his receivables to pay the taxes, incurring penalties and interest. After many years in public practice, I believe that the proposals required for farm operations to use accrual accounting would have a detrimental impact to food producers whom it would affect and impact. These proposals would have no additional cash available to pay tax payments, cash that would otherwise be used to grow business, create jobs, and serve communities in which those businesses operate.

Thank you for allowing me to testify today. I would like to thank Chairman Rice and other members of the Committee who have supported opposing limitations on the use of cash accounting. I will be delighted to address any questions from any member of the Committee today. Thank you.

Chairman RICE. Thank you, ma'am.

Our next witness is Terry Durkin, an enrolled agent and owner of Durkin Associates, a tax preparation and representation practice in Burlington, Massachusetts. Mrs. Durkin started Durkin Associates in 2006, after 21 years in the software industry, and was recently chosen as the president-elect of the National Association of enrolled agents for 2014 and 2015. She has a B.S. degree in applied mathematics from Yale University and an M.B.A. from New York University.

Ms. Durkin is testifying today on behalf of the National Association of Enrolled Agents. We appreciate you being here, and you may now begin your testimony.

STATEMENT OF TERRY DURKIN

Ms. DURKIN. Thank you, Chairman Rice, Ranking Member Chu, and members of the Subcommittee. I am Terry Durkin, an enrolled agent and president-elect of the National Association of Enrolled Agents, which represents the interests of over 46,000 enrolled agents across the country. I am also a sole proprietor. My practice is primarily focused on individuals and on small business of less than 500,000 in gross revenues, what I refer to as microbusinesses. Today, I share with you my perspectives as both a tax practitioner and a small business owner.

Over the years, it has become clear to me that the business checking account is the focal point for most small business bookkeeping. Small businesses use the business checking account to measure cash flow and profits, and to a great extent is their tax accounting. As a result, any change to the tax law that requires small business owners to move away from the simple checkbook accounting or cash basis accounting, has two negative effects with increased complexity and restricted cash flow.

As Congress begins reforming the tax code, I urge you to keep in mind how essential cash basis accounting is to startup businesses, especially these microbusinesses. I have six recommendations.

First, increase expensing under section 179. Because Congress has not enacted legislation to extend expired tax provisions, expensing of capital purchases is currently limited to $25,000. This is a big drop from the $500,000 deduction that was available for the last several years. Also, the purchase limit for section 179 property is $200,000. This, again, is a big drop from the $2 million total purchase limit of the past several years.

You can see the tax planning challenge we face when taxpayers do not know in advance which provisions may or may not be extended. I urge Congress to extend the section 179 expensing to at least $250,000, and to increase the total purchase limit to at least one million.

Second, remove uniform capitalization rules for small businesses. The uniform capitalization rules which were enacted as part of the

Tax Reform Act of 1986, requires certain direct and indirect costs attributable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property. I recommend that Congress consider removing this rule for small businesses and allow them simply to expense the costs.

Third, allow small businesses to use pure cash accounting even if they have inventory. In general, taxpayers must account for inventories if the production, purchase, or sale of merchandise is material to the production of income. In these circumstances, taxpayers must maintain inventory records to determine the cost of goods sold.

Fourth, allow small businesses to expense leasehold improvements. While the current list of potential tax extenders would provide some relief from having to depreciate improvements to lease property over 39 years, I urge Congress to allow these costs to be expensed under either section 179 or its own specific tax code section. A 15-year depreciation is certainly helpful but it can still be a problem for small businesses.

Fifth, allow small businesses to deduct all startup and organizational expenses. A taxpayer may elect to expense up to $5,000 of startup expenditures in the tax year the business begins. A corporation or partnership may elect to expense up to $5,000 of organizational expenditures in the taxable year the business begins. I urge Congress to allow all of these costs to be expensed for small businesses.

Sixth and finally, increase the limit on repairs and improvements. Under the new IRS rules, small businesses that lack a applicable financial statement, such as my microbusinesses, may expense amounts paid for property costing less than $500, rather than depreciating that property over several years.

Taxpayers must elect this new provision annually and must have documented business procedures in place. You can see, taxpayers must do a lot of paperwork here for a small benefit. I would recommend a rule that allows small businesses to expense these costs in the year made.

Based on my experience as a small business owner and as a tax practitioner, I believe the above recommendations would substantially simplify operations, ease paperwork burdens, and improve cash flow for many businesses.

Thank you for your time and attention.

Chairman RICE. Thank you, ma'am.

I will now yield to Mrs. Chu, who will introduce our final witness.

Ms. CHU. It is my pleasure to introduce Mr. Stephen Mankowski, the national tax chair and national secretary for the National Conference of CPA Practitioners. He is also a partner at EP Caine and Associates CPA, LLC, where he advises individuals and small businesses on issues related to accounting, taxation, business consulting, and litigation support services. Mr. Mankowski has a unique view of running a small business and also representing small businesses that rely on him for business management and accounting advice. He is a graduate of LaSalle University.

Welcome, Mr. Mankowski.

STATEMENT OF STEPHEN MANKOWSKI

Mr. MANKOWSKI. Thank you, Mr. Chairman, and Ranking Member Chu.

Again, my name is Stephen Mankowski, and I am a CPA. I am the national secretary and tax policy chair of the National Conference of CPA Practitioners, and a member of the American Institute of CPAs.

If I were to ask the average taxpayer about the difference between cash and accrual basis of accounting, most would not know the answer. The same is true for today's business owners. Several times each year I am asked to write off bad debt. It can be written off under the accrual basis, yet not under the cash basis. Why? Because in the cash basis of accounting, if the income was never recorded on the books, it cannot be written off. Part of a CPA's job is to ensure that taxpayers comply with tax code. Many business owners do not realize that there are other considerations to operating a business, including keeping separate books and records, paying themselves a salary, additional tax filings, et cetera.

LLCs have become a common business structure for new small businesses. Often, the business owners, however, are not aware of the tax ramifications. LLCs can be taxed as sole proprietors, partnerships, or even S corporations. The choice of business structure, however, does not affect the accounting basis. I have found that small business owners simply think in terms of cash in and cash out. Many started their businesses after being downsized. They have lived their lives on the cash basis, so operating their business in this fashion simply makes sense to them. They provide us with bank statements, check stubs, and invoices to analyze their business activities and prepare reports that are used solely to prepare their tax returns. These owners do not have systems in place to fully track accounts receivables or payables. Further, they do not have the excess funds to put the systems in place. To convert their financial information into an accrual basis would require adjustments for uncollected revenue, unpaid payroll and related liabilities, prepared expenses, inventory, et cetera. The owners will not only be responsible for knowing what adjustments need to be made, but also their valuation.

Ultimately, despite the business owners' reliance on accounting professionals, the fiscal responsibility still falls on the owners. Converting to an accrual basis of accounting might simply be a one-time benefit for the government. Once the conversion is completed, the annual effect might not be significant depending on the type of business. Newer entities or entities with minimal accounts receivable or accounts payable would likely have a small tax increase and possibly even a tax decrease. Entities with a larger receivable base, however, would not be so fortunate. To convert, they would need to record all open receivables as current income and all unpaid bills as current expenses. The impact of this added income could propel the owners into higher tax brackets, which could lead into phase outs of itemized deductions and personal exemptions, phase-out of other deductions and credits, including tuition and

student loans when the increased income is reported on their individual tax returns.

In addition, taxpayers may find themselves subjected to the new 3.9 percent net investment income tax surtax that went into effect this past filing season. These tax increases will not only affect the taxpayers' federal income tax. Additional state and local taxes may also be due because these returns usually have to be filed on the same basis as the federal tax returns. Further, many municipalities also impose gross receipts taxes on all businesses.

If there is one common thread resonating from the IRS, it has been to reduce taxpayer burden. While this can mean many things, ultimately, I believe the IRS realizes that business and taxes in today's economy have become even more complicated. Requiring businesses to change their accounting method without any specific reason would truly be in conflict to what the IRS has been working to achieve.

In conclusion, the majority of businesses are permitted to choose their accounting methods. With the guidance of financial professionals, they are able to elect the most appropriate accounting method for them. Forcing a business to use the accrual basis not only complicates their business but also requires the owners to take time away from operations to focus on changing an accounting method. Ultimately, one does not start a business simply to focus on accounting. Forcing this change will do just that.

I would like to thank Representative Rice and the other members of the Committee for their ongoing support in opposition to the limitations on the cash basis of accounting. Thank you for the opportunity to present this testimony today, and I look forward to your questions.

Chairman RICE. Thank you, sir.

I am going to defer my questions until the end. I think we have some members who are in a little bit of a hurry.

So Mrs. Chu, would you like to start?

Ms. CHU. Thank you, Mr. Chair.

Mr. Mankowski, the goals of our tax system should be to encourage investment and ensure economic competitiveness while limiting complexity. I understand that cash accounting is easier and requires much less recordkeeping for small businesses. Most importantly, a business owner may not need formal training to understand how it works, and I hear this from my constituent small business owners time and time again. Can you describe how losing the ability to use cash accounting will affect the small businesses that you advise?

Mr. MANKOWSKI. Certainly. I will try to be as brief as possible with this.

Cash accounting is how many small business owners think, and that is how they have been making their living. Their goal is to just pay their fair share of taxes and to just manage their business and to pay their family expenses. Losing the ability to function under the cash basis and have to go into an accrual basis could hinder the growth of the businesses. If they know that adding a specific partner onto their practice would then result in that firm having to convert to an accrual basis of accounting could really hinder the operations of the business and could really question if

they need to add or where their growth is really going. In essence, it would stagnate growth, not promote growth. And ultimately, if the goal is to be competitive, that would make the firm that has to now account on an accrual basis of accounting, it could, in fact, make them less competitive in the environment or in their business environment, and ultimately, it is making their business more complex, not less complex. And ultimately, it would result in higher taxes to the owners of the business.

Ms. CHU. Okay. And Mr. Mankowski, Mr. Camp's draft language proposal is raising the gross receipts limit to $10 million, meaning any qualified personal service corporation over this limit must use the accrual method. Can you discuss the concerns about treating some business structures differently than others based solely on their income level?

Mr. MANKOWSKI. By treating them based on their income level, it will actually—again, it will really create a situation where that business might not be competitive against their competition. If they know that if they continue to grow their business they are going to end up paying more taxes, there are issues that could relate with pass-throughs to retired partners that now may end up getting a larger tax liability for income that the firm has not even received yet. And further, in going through, many of the small businesses, as was mentioned by Ms. Durkin, the small businesses do not necessarily have ample cash flow. And when it comes time for paying their taxes, especially newer businesses, they may not have planned accordingly even with the assistance of their accounting professionals for what their liabilities may be. And ultimately, making this more complex makes it much more convoluted for the owners and takes them away from what their goal is, which is operating their business.

Ms. CHU. Thank you.

Ms. Windham, personal service businesses, like lawyers and architects, often work on a contingency basis for their clients. I understand you have personal experience working with construction contractors whose payments are often delayed. Can you explain how these payment structures work with both cash and accrual accounting and which method is preferred by businesses that you work with?

Ms. WINDHAM. Well, as I mentioned in my statement earlier, I had the example of a client who received his receivables very late and was forced to extend his tax return. And actually, in his case, incurred a fair amount of interest and penalties because he was forced to use the accrual basis of accounting. So I think that is a perfect example of the effect it would have. Had he used cash basis accounting, he would have waited another year to report that income in the year that he actually received it as opposed to having to extend his tax return and pay the interest and penalties that were calculated due to that. And he was in a situation where it was very close to the filing deadline, so had he not been able to collect those in time for the filing deadline, he may have been forced to borrow the money to pay his tax liability under the accrual basis of accounting.

Ms. CHU. Thank you.

Professor Williamson, in support of simplifying the cash accounting method, your testimony detailed the differences and difficulties that small businesses face when complying with current cash accounting rules, such as various judicial doctrines and exceptions to expense reporting. Does the Camp draft proposal alleviate some of your concerns, or what recommendations would you make to the current Camp draft proposal?

Mr. WILLIAMSON. Representative Chu, I am here today to represent small businesses, and our view is that small businesses need the cash method of accounting. Period. I know many large businesses also are on the cash method and feel very strongly they need to stay that way despite the Camp proposals. But I would like to emphasize that taxpayers be given as much latitude as possible in electing their method of accounting, be it cash or accrual method. I just see constantly my clients—I have a practice in Falls Church—simply do not understand the accrual method. They are cash basis people. Cash in, cash out. It is the balance in the bank account that concerns them most month to month, and that is what I am here to speak to today.

Ms. CHU. Thank you.

Ms. Dunkin, you suggest allowing small firms—I mean, Durkin. You suggest allowing small firms to use pure cash accounting even with inventories, which is currently disallowed as inventory accounting can be complicated. How would such a recommendation make it easier for small operations with inventories?

Ms. DURKIN. Sure.

So I think it really is a matter of timing when you can take the income and the expenses. So by allowing a small business to really keep to their checkbook, what they bring in and what they take out, whether there is inventory involved or not, really does make it easier for them to do their operations. So by having the ability to not have to deal with inventory really does, although it is a matter of timing, to make it simplified and stick with the pure cash accounting.

Ms. CHU. Thank you. I yield back.

Chairman RICE. I am going to start with Mr. Mulvaney because I think he has some other obligations.

Mr. MULVANEY. Thank you, Mr. Chairman. I appreciate the accommodation from you and from my fellow colleagues.

Back when I was a normal person, before I had this job, I had experience with both cash and accrual methods. I had a restaurant company that we used to run on a cash basis, a law firm that was on a cash basis, and then I ran a real estate company that was forced because of the nature of its business and the size to run the accrual method of accounting. So I have sort of seen it from both sides. And I remember very vividly the ugly reality of being in the accrual business, having to pay taxes on earnings that I had not collected yet. And I did not care for that very much.

Ms. Windham, you have mentioned that you have got a large Ag business, agribusiness stable of clients and it is something that is important to me because where we are from, both Mr. Rice and myself, we have large ag businesses in our district, tell me what it means to a farmer, and do not talk as an industry, because every time we talk about $4.8 billion of this it sort of gets lost. Tell me

what the individual farmer, what it means to him or her if the law changes and they have to change from accrual to cash. What does that mean in terms of what they have to go through and what they have to pay?

Ms. WINDHAM. Sure. I think to address the first part what they would have to go through, you know, we have dealt with this with clients who have banking relationships. For example, in my testimony, that just do not understand that farmers operate on a cash basis and the bankers ask them to do it on an accrual basis. It is very difficult for them to track their work in progress or their inventory, to estimate what their corn may be worth at the end of the year as commodity prices fluctuate.

Mr. MULVANEY. And let me stop you there for just a second, because you mentioned—I want to drill down on this a little bit because you just mentioned words that make sense to you and me but not to ordinary citizens, which is estimating your work in process, and in this particular circumstance, what your corn is worth at any particular time. Tell us what that involves?

Ms. WINDHAM. For example, the work in progress. Throughout the year, as the farmer starts, usually in our state at least, sometime in the spring, planting. So they have seed, they have fertilizer. They are spraying throughout the year. They have labor cost, which can be extremely high for the planting, as well as the picking or whatever they may be doing. And that would entail their work in progress. So throughout the year as they spend money on the cash basis, for example, they expense these items. On the accrual basis, they would have to track these items throughout the year and accumulate them as inventory and then determine as they sell their corn or their peaches or their blueberries or whatever it may be, how much of those expenses they have accumulated are attributable to the blueberries or the peaches or the corn they just sold.

Mr. MULVANEY. And that is subject to be second guessed by the IRS, is it not?

Ms. WINDHAM. Absolutely it could be. I could see it being very difficult, for example, we will use corn because I have a lot of farmers that are row crop farmers. If they have hundreds of acres of corn, and they buy seed and fertilizer in large bulk quantities, how do you determine I sold all of the corn in these five acres today and three weeks from now I am going to sell the corn on the other 10 acres? You know, what portion of my seed and fertilizer did I use on these five acres versus those 10 acres when I bought it all at the same time in March? It could be very difficult for them.

Mr. MULVANEY. Tell me about the process, because I have never gone through a conversion. I have never had to take a company from cash to accrual. Tell us what that means for a farmer.

Ms. WINDHAM. For a farmer, it means bringing someone like me in usually, which can quickly add up, depending on what kind of recordkeeping they already have. Most of the farms——

Mr. MULVANEY. Because the recordkeeping for the two methods is entirely different?

Ms. WINDHAM. It is entirely different. Correct. They are used to maintaining basically like a checkbook, which several people have mentioned, and that is easy for them. They can know what

they start the year with in their checkbook and what they finish the year with in their checkbook, just like we all do with our personal checkbooks. Switching it to accrual basis can be very costly from a standpoint of having someone assist them, as well as just difficult in that the records do not convert very easily and that is not how they operate their businesses. Commodity prices fluctuating on a regular basis can make it difficult. Which price do you use today and which price do you use when you make the conversion three months from now? So it can be extremely challenging, not to mention we do not have many farms in downtown Charleston or in Washington, D.C. They are out in very rural areas and you do not see too many CFO controller-type people living in those rural areas. So it may be very difficult for a farm owner to hire on staff the talent that they need to make that conversion on a regular basis.

Mr. MULVANEY. Thank you, Ms. Windham. I appreciate the testimony.

Ms. WINDHAM. You are welcome.

Mr. MULVANEY. Thank you, Mr. Chairman, for the opportunity.

Chairman RICE. Thank you, Mr. Mulvaney.

Mr. Schneider?

Mr. SCHNEIDER. Thank you, Chairman Rice. Thank you for calling this hearing. It is a critically important issue.

I bring my own personal experience to this. My father is a CPA. Had an accounting firm. At the time, it was one of the largest ones in Denver with 35 partners. I started my career in consulting at Price Waterhouse as I am thinking about it, 30 years ago this week, and before coming to Congress 10 years ago, I was in consulting with what was then the largest single-office private accounting firm in the country, a firm called Blackman Kallick. I understand the issue on a personal level having my own consulting firm, so thank you all for being here and talking about this critically important issue.

Professor Williamson, I know you talked about this being an issue for small businesses, but it is an issue for a lot of businesses. An accounting firm, or in my case a consulting firm that just needs a couple of partners working together quickly exceeds $10 million, but the impact on these professional service firms that have to book expenses and then not get paid many times for six to 12 months later would be profound. And to that end, I am circulating a bipartisan letter. I am pleased to have people on both sides of the aisle working on this issue with Congressmen Luetkemeyer, Quigley, and Hudson, and we want to draw the attention to the importance of cost accounting. I would invite my colleagues to all join us on that letter.

Speaking of agriculture, Ms. Windham, you know, my district does not include a whole lot of agriculture, but we appreciate the value of the food—the corn, the blueberries, the peaches, that we eat. And understand that a vast majority of that still comes from the family farm. And those farms require the ability to do their accounting in such a way that makes sense for their business, and that is crucial. The burden of having to transfer from cash to accrual accounting for a farmer, for a professional service firm, obvi-

ously is significant. Farmers and ranchers rely on this flexibly to deal with the commodities and weather. There is a lot of uncertainty in business. We all deal with that regardless of the business we have. Adding another level of uncertainty is, I think, the last thing we should be doing. And that is why this is important.

But it is not just agriculture. It is not just consultants and accountants. It is dentists. It is engineers. It is architects. So many of these professional service firms, partners working together individually rely on this, and as I mentioned before $10 million for a group of people working together adds up fairly quickly, but the impact on the individual becomes severe, and oftentimes it is going to affect retiring partners as was said before, and we need to touch on all of those.

I guess, Ms. Windham, I will touch with you. The impact you talked about, the cost to convert for a farm, what is the cost to convert for an accounting firm? What would be the impact there?

Ms. WINDHAM. I think one of the biggest costs for an accounting firm would be, one, keeping up with the receivables and payables, but two, as you bring partners in and out, new owners in and out, and I believe someone mentioned it in their testimony earlier, you could have a retiring partner who is forced to pick up income that may be received after he leaves the firm and retires, because it is an accounts receivable, and I know we have experienced in the prior five or six years with our clients struggling, you know, it may take six to 12 months to collect a receivable as you mentioned. And then the other side of that would be new partners coming in. It may be difficult for them. If a new partner were potentially to come in in a year of this conversion, they could be hit with a tax liability that they were not expecting, not to mention, a tax liability they do not have the cash to pay. So I think that is one of the biggest potential challenges for an accounting firm or a law firm or a professional service firm, is transitioning partners in and out and then the massive amount of tax liability that may be experienced with no additional cash. It would take cash away from hiring new accountants or attorneys, from creating jobs, from giving back to our communities, from those types of things, and we just do not have the cash savings to be able to afford to do that.

Mr. SCHNEIDER. Mr. Mankowski, you talked about competition briefly and the challenge it is for companies to compete. If you take two small businesses, one on a cash basis, one on an accrual basis, what are some of the disadvantages to the cash basis having to make the switch or compete?

Mr. MANKOWSKI. One of the advantages, or disadvantages, rather with the business that is going to be forced to switch over to an accrual basis is that within an accounting firm, as an example, there is generally not a lot of accounts payable they are going to be having, especially as you get towards yearend. However, you could be sitting with a considerable account of accounts receivable from some clients that may have done their yearend or with a plethora of clients that file tax extensions, and also clients that may have been billed for yearend tax planning that you may not receive the funds until the following year. The firm that is on the cash basis, they are not recording that in as revenue, so that may potentially allow their partners to keep those rates maybe a little

bit lower for their clients because they are not going to have to absorb in a higher tax liability for the individual partners. So in that situation, the firm that is now going to be converting or has already converted into an accrual basis, the owners may be at a disadvantage due to the receivables at the end of the year and higher tax liabilities.

Mr. SCHNEIDER. Great. Well, I have many more questions. I am out of time. Thank you for the extended time. I want to thank, again, the chair and the ranking member for calling this crucially important hearing on an issue. As our economy grows, we need our small companies, our middle market companies to grow, and this is important to allow them to do that.

Thank you very much.

Chairman RICE. Chairman Hanna.

Mr. HANNA. Thank you. Thank you for letting me in on this Committee. I am not normally here.

I have never heard such unanimity in my life between people. It is nice. And I agree with you as a guy who was in business for many, many years.

One of the things you mentioned, Ms. Windham had mentioned it also, Mr. Williamson, is that the possibility exists when you make someone convert to accrual who was on a cash basis, to actually wind up paying taxes on money, and you talk about construction, Mr. Mankowski did and Ms. Durkin did, those people have the possibility of actually owing money on money they may never receive. Owing money on litigated construction that they may ultimately win, having to go to the bank, borrow money, pay interest, pay taxes, and find themselves holding the bag. Because everything does not come in in a few months. Some things come in—and then you have the conversion issue of 10 years, trying to—recapture I think is the language that you used—built-in gains, which is a problem that a lot of people face.

So let me start off by saying, you know, I agree with you, but I want to understand the other side of the issue a little bit because, Ms. Durkin, when you talk about being able to write off inventory, one of the problems with that for the IRS is simply if you are a growing business, all you need to do is grow your inventory and you may never pay taxes as you grow until you close. And Mr. Williamson made a wonderful point, and that is that everybody ultimately winds up paying the tax they owe, but it is all a little bit about timing, is it not? It is a little bit about how do you manage your taxes and postpone it? How do you, as gamblers use the word, kiting checks, you can kite money. Right? You know what I am talking about.

So from the IRS's point of view, if you are going to take the other perspective, because I am guessing this is about making it a little bit easier for people to company and for them to actually understand the nature of what you are doing. So Mr. Williamson, what would you say if you were an IRS agent? How would you respond?

Mr. WILLIAMSON. If I were an IRS agent I would welcome this proposal of going more on the cash basis because some of the nuances of the accrual method, some of the uncertainties—when did you receive the income, when can you write it off as a bad debt—I think going on the cash method takes so many uncertainties that

IRS agents have to interpret when they apply the law when they go out to a client or to a taxpayer. I would think the IRS would applaud this. And as you have already said, Mr. Hanna, this is all about timing because over the life cycle of the business the amount of economic income and the amount of economic expenses will be incurred. And ultimately, the same amount of tax will be paid under either the cash or accounting method, no question about that. And your point is well taken. This is about timing. And I can understand why perhaps the Treasury Department and certain members of Congress would want to be on the accrual method because that would, in some cases, accelerate income into earlier years for purposes of scoring a tax bill.

Mr. HANNA. Right. So basically, what we are saying is you can pay now or pay later, but you are going to pay, and it is just a matter of whether you hold your money a little longer and the IRS gets theirs a little sooner is really——

Mr. WILLIAMSON. And as Ms. Windham pointed out, whether you have to borrow the money to pay the tax.

Mr. HANNA. Do you agree, Ms. Windham?

Ms. WINDHAM. I do. Yes. I think it does, quite honestly, make it easier for the IRS as well because they are attending the same continuing education and the same training that a lot of us are attending as CPAs. And as you are well aware, the tax code is pretty tremendous. Even for an IRS agent knowing every part of it can be challenging. So simplicity I think is better.

I think, as well, unless there is some type of individual tax return that coincides with tax reform for S corps, C corps, and partnerships, that under a progressive tax system you could potentially pay more taxes over the same period of time as you would even though you are going to incur the income or expenses. For example, with farmers, it may be really high in a good year and the next year we may have a drought and it would be really low, and the year that they have high income, they are going to pay a higher rate.

Mr. HANNA. And we have no more income averaging. It used to be around. It is not anymore. So that is an issue for someone in your business.

Ms. WINDHAM. Right. Correct.

Mr. HANNA. I want to ask you, I have just got a few seconds left here, but the economic value of letting people keep things simple I would say is huge, and it benefits the country ultimately because they make more money. Do you all kind of agree with that? Anybody?

Ms. DURKIN. I do, and I think taking some comments that Chairman Rice has said in the past, small business owners are America's economic engine, and we need to fuel that engine, and cash is that fuel. So by allowing the small businesses to use the cash accounting really does fuel that and powers the economy.

Mr. HANNA. Thank you. My time is expired.

Chairman RICE. Mr. Schweikert?

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

First, a one-off question just because of an experience we had a couple years ago. Have any of you had the experience of doing a conversion and someone that uses one of the online softwares for

the management of their business and having some real troubles getting it to work in regards to bad debt, some inventory issues? So I guess it is sort of a universal question of for right now, any experiences, first of all, on the cash basis, small business accounting softwares, what they do with bad debt, and then particularly a small business that might be using accrual?

Mr. MANKOWSKI. Mr. Schweikert, first, under the cash basis, although many of our clients do think that they can write off bad debt, currently, if they are filing under a cash basis, they are not permitted to write off bad debt. As I had mentioned in my testimony, every year I get asked the same question by a number of clients.

Mr. SCHWEIKERT. But to that point, have you ever had someone present to you saying here is my software and look, it has a category for this?

Mr. MANKOWSKI. Absolutely. And I go through and I tell them that they are not allowed to and they ask why. And I tell them, well, you never declared the revenue, so you cannot turn around and take the expense. We will gladly put the revenue in this year, and it is only going to offset and you will get zero impact from it.

Mr. SCHWEIKERT. Ms. Dunkin? Or Durkin?

Ms. DURKIN. I have had the same situation as far as clients.

Mr. SCHWEIKERT. Hit the mic.

Ms. DURKIN. Thank you.

I have had the same situation of clients saying I never got paid for this and then the discussion is, well, did we ever claim it as income? No. So you are not allowed to claim that expense.

Mr. SCHWEIKERT. And I am going to skip to the professor because I want to come back to Ms. Windham.

Professor?

Mr. WILLIAMSON. Yeah. I think what you are illustrating, Mr. Schweikert, is exactly the confusion that taxpayers have and small businesses have and why we are advocating the cash method of accounting. Why can I not take a bad debt? They did not pay me. Well, you never recognized the income in the first place. And I cannot tell you, and I think all of us at the panel have had the experience with our clients where we try to tell them this and they just do not get it. And what that demonstrates is how we need the cash method of accounting to show them cash in, cash out, and really eliminate the bad debt issue entirely, other than for those firms that should be on the accrual method.

Mr. SCHWEIKERT. Ms. Windham, because you actually personally generated my memory of this question in a couple of your comments in regards to difficulty in collections and sometimes negotiated settlements on pay as this percentage of our bill and then complete write-offs, and the difficulties sometimes that causes for even cash accounting when you are breaking over your year, and then the difficulties I have seen with a couple of our personal businesses and those we have helped on that they are using software and the software keeps popping up. Why are you not telling us this? Am I the only one to have experienced this?

Ms. WINDHAM. I can speak to a very similar situation actually that has happened in the past month or two. We have a client who has an investor who is an attorney who uses the cash basis in his

firm because he is an attorney and is allowed to. This particular client of mine is required to be on the accrual basis and prepares their books on an accrual basis. Well, he has asked for a cash basis statement from my client because that is what he understands. And in this particular situation they are using QuickBooks, which is a software that many, many, many clients use across the country.

Mr. SCHWEIKERT. I was trying to avoid mentioning any——

Ms. WINDHAM. Well, I started not to, but anyway, and it is extremely common in small businesses. And because of the way my particular client operates, and obviously, I do not want to disclose their financials, hitting a button, so to speak, to convert to cash basis is an option. However, because of the way they track certain things, the software does not do it correctly because of the way they have to input it. And it is not a software issue, it is an input issue, and there is no other way to input this data for it to convert correctly. So we have been struggling with explaining to this attorney why we cannot produce cash basis without a lot of work.

Mr. SCHWEIKERT. Have you run into the other externality when there are other partners that you are paying out and the problem of we have not recognized the income but——

Ms. WINDHAM. Yes. We see that a good bit where we have questions on, for example, a partner has a tax liability on their individual tax return because they are receiving a K1 with income from the partnership. However, they have not received the related cash. And the first question is how can I have income and tax if I do not have the cash? And you have to explain to them, well, you have half a million dollars in accounts receivable which you have yet to collect, and when you collect those you will have the cash. And it can be a very difficult pill for a partner in a partnership to swallow when they have a large tax liability and no related cash to go with it.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. Having run into some interesting issues in this sort of mechanic where a lot of partnership agreements are written where you owe a certain rate of return or pref on sometimes not actually realized income but in booked income. You do end up in this kind of cascade of problems and borrowing money to pay your partners. So with that I yield back, Mr. Chairman. Thank you for the patience.

Chairman RICE. Thank you, sir.

Mr. Payne?

Mr. PAYNE. Thank you, Mr. Chairman.

Ms. Windham, I understand that you support the cash accounting method, but as someone who assists small businesses, do you also believe that some of the current cash accounting rules are too complex and seem to unnecessarily try to match accrual accounting as Mr. Williamson suggests? Based on your experience, do you believe that the current Internal Revenue Code cash codes should remain as is or need changing?

Ms. WINDHAM. I think the current cash accounting rules and the Internal Revenue Code are pretty easy for businesses to follow. There are quite a few exceptions and twists and turns as with anything in the Internal Revenue Code, but for the most part, small businesses can use a checkbook-type method of accounting. There

are some, as Ms. Durkin mentioned, some issues in there with inventory, depreciation, repairs and maintenance that could, quite honestly, be simplified, and I think she made some great points in her testimony on simplifying repairs and maintenance. There is a new regulation written on that recently that complicated it in my opinion. Depreciation could be made a little more simple with making it permanent instead of extending it every couple of years and causing uncertainty for small businesses. Inventory, obviously, as she said, is another issue that can be a challenge for small businesses to track their inventory and not expense it when they actually write the checks. So I do think there are some ways in there to simplify accounting for small businesses, and I think her testimony spelled that out pretty accurately. But true cash accounting needs to continue for small businesses to allow them to be able to deal with the challenges of running the rest of their business and not have to focus on their books on an hourly or daily basis.

Mr. PAYNE. So it can be very easy but then you also say it is very complex?

Ms. WINDHAM. Yes.

Mr. PAYNE. Okay. All right.

Ms. Durkin?

Ms. DURKIN. Yes. I will give you one example of a client who became a client, who was in the theater production. He was starting up to create a theater. He bought—leased a building and put $300,000 into leasehold improvements. And sadly, he thought that whole $300,000 would be depreciated in that year because he spent it in that year, and I had to be the one to tell him. And when he came afterwards to me to prepare the return, well, you cannot take the whole $300,000. Some of it we can do 15 years, some of it we have to do 39 years. So this cash basis person all of a sudden then had these three different ways he could take this deduction and not the deduction that he wanted to. So you can see some challenges like that.

Mr. PAYNE. Sure. Thank you.

Mr. Mankowski?

Mr. MANKOWSKI. Thank you, Mr. Payne.

I can agree with some of the comments. One of the things that ultimately I think we need to look at is not just if we are going to move the threshold from a $5 million to a $10 million, the $5 million threshold I believe went into effect with the Tax Reform Act of 1986. Similar to many of the items in the tax code, they have stayed there and stayed there, but they have not been inflation indexed and now they are just looking to come up with a number. If they are going to increase it and actually keep a threshold, they should probably look at some level of an indexing, starting from ’86 moving forward, or potentially even look to remove the threshold and just allow a business to operate so that as many of us have mentioned, we are not going to all of a sudden you have a good year, whether you are a hedge fund or whether you are an attorney who lands a big case, all of a sudden you need to convert to an accrual basis the following—after you are out of that three-year averaging. If you are now below the threshold, are you then allowed to convert back to cash basis because you are no longer in that threshold? There are some of the complexities that simply doing

away with any type of a revenue threshold, even on an average basis, would really work towards simplifying and allow the owners to do what they do best, which is operate their business. And that is why all of us are in the accounting profession. That is what we do best, which is help them manage their accounting aspects so that they do not have to worry about that part of their business.

Mr. PAYNE. Thank you. And in the interest of time, I will yield back.

Chairman RICE. Thank you, sir.

Well, this has truly been a very interesting hearing. I have learned a lot from you guys, and I appreciate you all being here. My concern in all this is that here we sit six years after the Great Recession, and we have still an economy that is struggling, negative 2.8 percent growth in the last quarter. Millions of people dropped off the employment—the workforce because they find it so difficult to find employment. American jobs, every day you turn on the TV and you see more companies moving over to corporate inversions now, but that is really more jobs moving overseas. And I think a lot of that comes from anti-competitive policies that come out of Washington, D.C. I think we make it too complicated. I think we make it too difficult. And I think we cost businesses too much. Too much in taxes. Too much in red tape. And I think that is what I hear from you guys. It is one thing to not create impediments, but it is another thing to actually throw up impediments to hiring and expansion. And I see that in government. And Mr. Mankowski, I think you referred to that earlier when you said the accrual method could actually put up impediments. Is that correct—to hiring and to expansion—is that right?

Mr. MANKOWSKI. That is correct, sir.

Chairman RICE. Can you explain that further?

Mr. MANKOWSKI. Certainly. If you have—and I will take my position. I recently merged my accounting practice. If we continue—and we have been growing our practice daily with more and more clients—if we bring on additional partners that may bring additional revenue into our firm, expand our services, if we get to a point where we, at this point we hit a $5 million threshold, the firm would then have to go through converting to an accrual basis. At that point, is it really worth bringing on an additional partner who may kick you into having to go to accrual basis? Or maybe go and, not that we, as accountants, know our way around the system, but potentially spin off part of a practice. I will stay a partner in my firm. I am going to spin off part of the practice to one of the other partners. That will be a separate entity, and now we are staying under the thresholds.

Chairman RICE. And that does not add to complexity at all, does it?

Mr. MANKOWSKI. None. It does not add to the complexity, but it——

Chairman RICE. Oh, it does. When you maintain separate entities.

Mr. MANKOWSKI. But in that case, it is keeping you out of the thresholds which is not what we want to do.

Chairman RICE. Does that make you more productive?

Mr. MANKOWSKI. Absolutely not.

Chairman RICE. All you are trying to do is work through some loophole. Is that correct?

Mr. MANKOWSKI. Unfortunately, that is what it comes down to.

Chairman RICE. Ms. Windham, do you agree that this law, forcing people to apply with the accrual method, that that actually makes firms consider not expanding and not hiring and not bringing on new employees?

Ms. WINDHAM. Yes, absolutely. I mean, some of the statistics I have seen with taxes that would have to be paid without the lack of additional cash, obviously, that prohibits firms, attorneys, accountants, whoever, from taking that cash that they have been reserving for growth, expansion. It may be in the case of a farm, building a new building or purchasing a large piece of equipment or adding a production line. They are going to use that cash to pay tax instead of growing jobs, growing the economy, and growing their business.

Chairman RICE. And I know this is a hot button topic, but the Affordable Care Act forces people to limit their workers to 30 hours a week, forces them to stay under the 50-person threshold. So you see these policies out of Washington who everybody stands up here and says we are for jobs, but what they do is something different. The policies that come out of Washington actually stifle expansion and stifle job growth.

Do you agree with that, Ms. Durkin?

Ms. DURKIN. Yes. The example of the new IRS regulation about the repairs versus capitalization, for the small businesses, they have to do a considerable amount of paperwork, declare a capitalization policy, and put it on their return each year for $500. I had a client who had a rental property and he bought an $800 washing machine, so he did all this paperwork and he still could not use it for this purpose, so there are—the intention is a good one, but practically when it gets down to it, some of the thresholds are just too low.

Chairman RICE. There have been reports coming through this Committee that fairly routinely say the cost per—small businesses employ 70 percent of the people in the United States, and the cost per employee to a small business in terms of regulatory costs, which includes tax compliance, is like $10,000 per employee. It far exceeds the tax liability.

Professor Williamson, do you see this as a meaningful——

Mr. WILLIAMSON. As I hear you speak and the other panelists speak, what I think is going on here from an academic perspective is our advocation of the cash accounting method does indeed violate the matching principle of accounting, which is somewhat of a catechism, that you want to match your revenues with your costs, and that is the basis of the accrual method. And people in the Academy would agree that the accrual method is a more accurate method for keeping track of your books and records.

That said, for small business, as we have said, all of us here in our testimony, it is about the cash. And we can set different thresholds—$5 million, $10 million. I even hear some rumblings that maybe it should be even higher. And for small businesses, it

is all about the cash and it is not about some theoretical matching principle of revenue with cost.

And with respect to the repair regs, we advocated in the Tax Center that $500 be $5,000, which they gave to the large businesses, but not to you and me.

Chairman RICE. I hear you. And I agree with you. But the average small business guy, he does not know what you just said. And the average person out there watching C-SPAN does not know what you just said. So my bottom-line crux issue is the effect on American competitiveness and jobs. And my theory is that the complexity created by Washington, and the accrual method being one of those, decreases our competitiveness and puts burdens on job creators. Do you agree with that?

Mr. WILLIAMSON. Absolutely. For small businesses, no question.

Chairman RICE. Okay.

Mr. WILLIAMSON. They can hire Ms. Windham or they can hire a new employee.

Chairman RICE. What I am worried about is my sons and my grandsons and my granddaughters getting jobs. And what I want to do is put us in a position that makes them more competitive in the world.

Mr. WILLIAMSON. Absolutely.

Chairman RICE. This is just one more addition, one more burden on farmers and small businesses. Is that correct?

Mr. WILLIAMSON. Yes. Or advocacy here with the cash method of accounting is lighting a candle. We have heard some candles about cursing the darkness. We are advocating here, we are lighting one candle to ease the burden upon small business with respect to the method of accounting they choose in their business.

Chairman RICE. Let me ask you this. The Ways and Means proposal, Dave Camp's proposal they referred to earlier, does that simplify the burden on small businesses or does that exacerbate the burden on small businesses?

Mr. WILLIAMSON. As I understand it, it enables small businesses to continue the cash method of accounting.

Chairman RICE. And it increases the threshold generally?

Mr. WILLIAMSON. Yes.

Chairman RICE. Ms. Windham, do you agree with that?

Ms. WINDHAM. It does increase the threshold. I think it could have some consequences that people may not be aware of though. For example, farms would be a great example of that. You know, farms are traditionally passed down from one generation to the next, and obviously, as you continue to pass down, you may be adding more family members, so there may be other businesses that are created, especially with the movement across the U.S. for farm to table and those kinds of things, you may create a retail market or a restaurant or a processing component. And if you have a related party that owns the farm as well as some of these other businesses, you may be forced to pull in the revenue for all the businesses together to calculate your gross revenue. So the farm may be, for example, forced to switch to the accrual basis of accounting which was not intended because the farm owner's sister happens

to have a retail market and they are forced to include revenues from both.

Chairman RICE. Okay. So the way I understand what you just said is Camp's, the Ways and Means proposal, actually expands the availability of the cash method but there are some particulars that you would like to see changed to make it even more available?

Ms. WINDHAM. Well, in his proposal specifically, the $10 million threshold, currently there is no limit on most farms, and that would obviously put a limit on farms specifically. So in both sides of it, putting a limit on farms, as well as putting a limit on other businesses who may be forced to use these aggregation rules to include multiple lines of their businesses because they are related family members or owners.

Chairman RICE. Thank you.

Mr. Mankowski, you said something at the very beginning of your testimony, and I do not want to mischaracterize it, and I do not think you meant it this way. It almost sounded like you said the accrual method had an advantage and that you could write off bad debt. But under the cash method, that money would never have been taken in income anyway. So the net result is zero under either method. Is that correct?

Mr. MANKOWSKI. Yes, sir. That is correct.

Chairman RICE. All right. Well, unless anybody else has any additional questions they want to ask.

Ms. CHU. I would just like to enter into the record the written statement from the American Bar Association, which lays out their concerns on how the draft tax reform proposals would affect these small law firms throughout the country.

And I would simply like to thank the panelists. I was impressed by the unanimity of your statements and also your very vivid examples of how this would affect small business.

Chairman RICE. And I appreciate your specific recommendations for how we can make things better, you know, your list of items, Ms. Durkin, you listed in yours; particularly, Professor Williamson, so.

Mr. SCHWEIKERT. Mr. Chairman, if I can, as well, I would like to enter into the record testimony of Jeffrey Wald, who is the CEO of an accounting firm, Kennedy and Coe, LLC, that specializes working with agriculture businesses and understands and says I think very—clearly states some of the challenges these businesses face and the advantage of the cash accounting method.

Chairman RICE. Thank you, sir.

Okay. Thank you all for participating today. While tax and recordkeeping complexity causes concern for so many small business owners, it is clear that the use of the cash accounting promotes simplicity. Moving forward, we must ensure that our nation's job creators have the flexibility to utilize the accounting method that allows them to thrive. Today's testimony will be helpful as Congress looks for ways to make our tax policies more simple, predictable, and rational. It has been an honor for me and the other members of the Subcommittee to hear from this group of industry leaders and small business owners.

I ask unanimous consent that the members have five legislative days to submit statements and supporting material for the record.

Without objection, so ordered.

The hearing is now adjourned.

[Whereupon, at 11:16 a.m., the Subcommittee was adjourned.]

APPENDIX

Testimony of

Professor Donald T. Williamson

Howard S. Dvorkin Faculty Fellow

Executive Director, Kogod Tax Center

Kogod School of Business American University

Washington, D.C.

Committee on Small Business

Subcommittee on Economic Growth,

Tax and Capital Access

United States House of Representatives

Hearing on

“Cash Accounting: A Simpler Method for Small Firms?”

July 10, 2014

Chairman Rice, Ranking Member Chu and Members of the Subcommittee, thank you for the opportunity to testify on the need to simplify the tax reporting requirements on small businesses by means of adopting simpler methods of tax accounting.

My name is Don Williamson and I am a professor of taxation at American University's Kogod School of Business where for the past thirty years I have been the Director of the School's Masters in Taxation degree program. The MST program at American University offers graduate courses in federal taxation to CPAs, experienced accountants, attorneys and others who wish to expand their knowledge of our nation's tax law. Our course offerings not only include traditional classes in subject areas such as the taxation of corporations and partnerships, international taxation and tax policy but also more specialized areas of the tax law such as accounting periods and methods which is the topic of this hearing today. As part of my responsibilities at American University, I am the Executive Director of the Kogod Tax Center which conducts nonpartisan research on tax issues affecting small business and entrepreneurs. For the past 25 years, I have had my own tax preparation and planning practice for small businesses in Falls Church, Virginia.

The Kogod Tax Center has previously testified before the House Small Business Committee on the most burdensome tax problems faced by small businesses. Today I would like to focus my remarks on one area in the Internal Revenue Code that can easily be changed to substantially reduce the record keeping and tax compliance burdens on small businesses namely, liberalizing the law to permit more small businesses to adopt the cash method of accounting rather than being required to use the more burdensome accrual method.

My testimony will describe and highlight the burden placed upon small businesses when the Internal Revenue Code requires them to be on the accrual method of accounting. However, even where the law permits a small business to use the simpler cash method of accounting, the general requirement to maintain inventory records creates burdens that may only influence by only a few months the timing of a small business's taxable income. Therefore, we urge Congress to not only expand the number of businesses eligible to use the cash method of accounting but to also enact a "simplified" cash method of accounting for small businesses that would further reduce unnecessary record keeping and compliance burdens. We believe such simplification will neither adversely affect the accuracy of tax returns nor impact the ability of the IRS to collect tax.

I. Cash Method vs. Accrual Methods of Accounting

Before describing our proposal for a simplified cash method, I would like to explain, for the benefit of the members of the subcommittee who may not be familiar with tax accounting rules, the two major tax accounting methods used by businesses, i.e. the cash method and the accrual method. I believe this explanation will highlight why for small businesses the accrual method is more burdensome than the cash method; and demonstrates that while the

accrual method may in some cases more accurately measure economic net income, why the complexity and cost of any additional precision is unnecessary and ultimately provides no greater tax revenue for the IRS.

Once a business adopts a tax year, and for most small businesses this will be the calendar year, it must adopt an accounting method which determine the time at which the business recognizes an item of income or may deduct an expense. It is important to note that a business's accounting method only affects the timing of when a business reports income or deductions on a tax return. The accounting method a business uses does not determine whether an item of income is taxable or an expense deductible and does not affect the total income and deductions a business will recognize over its lifetime.

Publicly traded corporations and many large businesses generate financial statements for the SEC or commercial banks based on generally accepted accounting principles (GAAP). Small businesses usually do not keep their books and records in accordance with GAAP, almost always relying upon their tax returns to provide lenders and owners with sufficient information to determine the success and credit worthiness of the business.

Under the Internal Revenue Code a small business is only required to choose an accounting method that "clearly reflects income" and apply that method consistently from year to year. Consistent with this requirement, most small businesses adopt the cash method of accounting unless the law requires them to use the accrual method.

A. Cash Method

A business adopting the cash method of accounting recognizes income when it receives actual payment for the goods or services sold, regardless of when the business sells the good or performs the service. Similarly, a cash method business is entitled to a deduction on its tax return only when payment for an ordinary and necessary business expense is actually made. However, even cash method businesses may not deduct certain types of payments when made. For example, a cash expenditure that creates an asset of the business with a useful life of more than one year but rather must "capitalize" the cost and depreciate (deduct) the cost over a prescribed "recovery period" in which the tax law presumes the asset will be consumed in the business. There are other types of cash payments subject to similar treatment. Thus, even the cash method adopts certain principles of the accrual method described below resulting in a mismatch of the time an expenditure is made and the time at which it can be deducted.

1. Judicial Doctrines of Income

In addition to requirements to capitalize certain expenditures there are several other technical requirements for a business computing taxable income under the cash method that are unnecessarily complex. Under the judicial doctrine of "constructive" receipt, a cash basis taxpayer must recognize income even when cash has

not come into the physical possession of the business but is merely available to the business at its discretion. Similarly, the mere receipt of a promise results in recognizable income under the cash method if the promise is convertible to cash before it matures, in which case the fair market value (that is, the "cash equivalent") of the obligation is recognized at the time of receipt of the promise. Finally, under the "economic benefit" doctrine, a cash method business must immediately recognize income on the receipt of property whenever the business's right to the property is absolute, even if not immediately assignable and even though it cannot be immediately converted to cash.

Such judicial theories that require a business using the cash method to pay tax on income deemed received prior to the receipt of cash unnecessarily imposes a severe cash flow problem on small businesses—a problem that creates only a marginal timing benefit to the IRS, since small businesses would most certainly receive the cash shortly after constructive receipt, economic benefit, or a cash equivalent arises. While these concepts offer comfort to theorists, small businesses must pay next month's bills, and the acceleration of any taxable income before the receipt of cash under these theories requires small businesses to use their operating cash to pay tax on amounts they have not yet received instead of using that cash to run their businesses.

2. Accounting for Expenses

An even more challenging problem encountered by small businesses using the cash method of accounting is the compliance costs and complexity associated with computing deductible expenses. Generally, the cash method permits a deduction for ordinary and necessary business expenses when actual payment is made. Thus, a promise to pay is not deductible until payment is actually made.

Although there may be confusion surrounding when and if a payment has been made, small businesses confront even greater difficulties when computing allowable deductions under the cash method because of four exceptions to the general rule that a deduction is permitted when payment is made, i.e. prepayments, depreciation, inventory and capitalization of some expenses. Prepayments for property or services are not deductible if the goods or services are provided more than one year after the prepayment. Costs exceeding $5,000 associated with creating a new business are not deducted when paid but amortized over 15 years. For inventory, the costs of its acquisition or production are deducted only when the inventory is sold. Similarly, property with a useful life of more than one year is generally subject to depreciation, requiring its deduction be spread over recovery periods ranging from three to 39 years.

These examples demonstrate that the current cash method of accounting is too often not based upon cash receipts and disbursements, but rather on principles that attempt to match costs with income similar to the accrual method. For small businesses that have no government regulators to whom financial statements must be submitted and have no banks or other creditors in need of profit

and loss determinations that conform to the rules of GAAP, tax rules based on the accrual method serve no practical purpose when economic success and taxable income can simply be measured on cash receipts and expenditures—that is, cash flow. In short, while the current cash method is substantially simpler than the accrual method, certain refinements to the current rules could make the cash method even simpler and more easily enable allow small businesses to comply with tax record keeping and reporting requirements without the loss of accuracy on their tax returns.

B. Accrual Method

The other major accounting method, the accrual method, attempts to determine the time at which "all events" occur that give rise to the right to income and the amount of that income can be determined with reasonable accuracy. Similarly, an expense may be deducted when the obligation to pay an expense is fixed, the amount of that obligation can be determined with reasonable accuracy and economic performance has occurred. Thus, businesses must report income on their tax returns when earned and may deduct expenses when incurred without regard to the receipt or payment of cash.

The accrual method and its "all events" test creates substantial complexity in an effort to better identify the financial success or failure of a business. This complexity calls for small businesses, whose every day well being centers upon its cash position, to determine its financial well-being in a manner that adds no value to its success. From the perspective of the IRS, while the timing of income and expense reported under the accrual method may provide some acceleration of tax upon income that must be recognized before any cash is received, such acceleration is clearly unfair if the cash is never received, and may only accelerate tax collection by no more than one year if the cash is subsequently receive shortly after the accrual.

The complexity of the accrual method is illustrated by prepayments. In the case of prepaid rent or interest received, income must be reported immediately upon receipt even if "all events" entitling the business to the income have not occurred. Similarly, where goods or services have not been delivered but cash payment has been received, the general rule under the accrual method that delays reporting the cash receipts on the business's tax return until "all events" have occurred, i.e. the goods are delivered or services performed, is disregarded. Thus, in the case of prepayments a business otherwise on the accrual method finds itself using the cash method for prepayments. Not an easy concept for a small business owner to understand.

Another complexity of the accrual method is the necessity to account for bad debts when a business reports as income an account receivable for which it never receives actual payment. Each year businesses on the accrual method must determine which previously reported receivables are uncollectible and claim them as tax deductions. This can be a time consuming, confusing and expensive proc-

ess. Businesses using the cash method do not deduct bad debts because they do not include receivables in taxable income.

Finally, even when a business on the accrual method meets the "all events" test with respect to an expense, a deduction may be claimed only when "economic performance" occurs. Therefore, in the case of receiving goods and/or services from another party, the business may deduct the obligation to pay the other party only as the goods or services are received regardless of when the business pays for the goods or services, subject to an exception permitting deduction in the year of prepayment if the other party provides the goods or services within three and one-half months of the next taxable year. Again, not such an easy concept for small businesses to understand.

The above illustrations of some of the complexity required by the accrual method of accounting demonstrates that in the case of small businesses the technical accuracy resulting from these rules offers no practical benefit to the business in measuring its economic performance, and over the life cycle of the business, offers no additional tax revenue to the government.

II. Tax Accounting for Inventories

Regardless of whether a business is on the cash or accrual method of accounting, if inventory is a material income producing factor, the business must account for gross profit, i.e. sales minus cost of goods sold, using the accrual method, even if they have adopted the cash method as their overall accounting method. Thus, a business cannot deduct the cost of the inventory (finished goods) to the extent it has not sold the product by the end of the business's taxable year. Businesses selling inventory must maintain records documenting their cost of unsold, finished goods, partially finished goods and "raw" materials on hand that will be used in the future to manufacture or produce inventory. In addition, inventory cost accounting principles call for the deduction of indirect costs (overhead) associated with manufacturing or producing the inventory only when the inventory is sold.

In determining its cost of inventory, a business must adopt an inventory costing method, i.e. the first-in, first-out (FIFO) method, the last-in, last-out (LIFO) method or the specific identification method. The FIFO and LIFO methods relieve businesses of the need to keep track of the cost of each item its sells, but where the items are unique or relatively high-cost, low volume products (e.g., jewelry, antiques, cars, etc.) the specific identification method is used.

As an exception to the requirement to maintain inventory accounts, the IRS (not the Internal Revenue Code) permits a cash method business to use the cash method to account for their gross profit from the sale of inventory if the business's average annual gross receipts for the three year period prior to the current year do not exceed $10,000,000 and the business's primary activity is to provide services to customers but also offers a product for sale incidental to the performance of services. Thus, a veterinarian using the cash method of accounting need not use the accrual method to

account for the sale of medicines or other goods associated with the business of caring for animals because such sales are incidental to the veterinarian's professional practices. But when the average gross receipts of the business exceeds $10,000,000, businesses must not only account for inventory using the accrual method, but also must apply certain "uniform cost capitalization" (UNICAP) rules that require an allocation to inventory of an array of indirect costs beyond those ordinarily associated with producing goods. Thus, under the UNICAP rules, a business must add to the cost of inventory a portion of compensation paid to employees who may not be involved in producing the inventory but may merely indirectly support the production process.

A final illustration of the complexity of the accrual method deals with the perceived abuse of an accrual method business accruing (deducting) an amount owed to a related party using the cash method. In this case the business using the accrual method may not deduct the amount owed to the related party until the amount is actually paid and recognized as taxable income by the cash method party. This issue frequently arises where a business employs the owner or a relative of an owner. Related parties, for this purpose, include family members and certain businesses owned by the same individual(s).

III. Comparison of Cash and Accrual Methods

As the above descriptions demonstrate, the primary advantages of the cash method over the accrual method are its clarity and flexibility in measuring income and expenses and its less cumbersome bookkeeping and record keeping requirements. While the accrual method is generally considered a more accurate reflection of a business's financial condition, the price of this accuracy is mind numbing complexity and inevitably increased compliance and record keeping costs.

However, the Internal Revenue Code limits the adoption of the cash method to the following businesses: (1) sole proprietorships; (2) S corporations; (3) certain corporations engaged predominantly in the performance of services by their owners; (4) corporations with average gross receipts over the preceding three years of $5,000,000; (5) partnerships with no corporate shareholder whose gross receipts exceed $5,000,000; and (6) farms.

Suggestions for simplifying and liberalizing the use of the cash method were made by the Treasury Department in 2007, and by the Bowles-Simpson Commission in 2010. These studies concluded that simplifying the reporting of income and expenses on tax returns filed by small businesses would result in the reallocation of resources to more productive purposes, ultimately stimulating job growth. In addition, the IRS Taxpayer Advocate has consistently recommended simplifying accounting methods for small business as a way to ease compliance burdens and reduce tax administration.

IV. Simplified Cash Method of Accounting ("SCM") - The "Checkbook" Method

Based on this brief description of the accounting methods available to small businesses and the observations of Treasury, IRS and independent tax reform studies, I believe that small businesses need and deserve legislative relief in measuring and reporting their taxable income and deductible expenses. In my view, the Internal Revenue Code should be amended to not only permit the adoption of the cash method by more small businesses, but also the adoption of a "simplified cash method of accounting" ("SCM"). This proposed simplification of the existing cash method of accounting will reduce time-consuming, expensive administrative burdens on small businesses in keeping records and reporting their income and expenses on their returns, thereby unleashing resources that will create more productive, job creating activities.

Besides reducing compliance costs the SCM will enable small businesses to better understand their tax returns, thereby reducing the general public's cynicism that the Internal Revenue Code is replete with loopholes only accessible to businesses with resources to employ expensive tax professionals. In short, I believe that simplifying reporting on tax returns will increase compliance, ease the burden of tax administration, increase tax revenue and ultimately reduce the gap between what taxpayers should pay and what the IRS actually collects.

Under the SCM the computation of taxable income is reduced to the following formula:

Cash Receipts

Less: Cash Expenses including:

- Inventory
- Prepayments
- Materials/Supplies
- Depreciable Property

Taxable Income

In short, the derivation of taxable income is based solely on amounts actually received or paid during the tax year, by means of examining the business's checkbook for when checks were cut and deposits made. Under SCM, income consists only of cash, property or services received during the tax year without regard to imputed income under the constructive receipt, cash equivalence, or economic benefit doctrines. While determining and valuing the receipt of in-kind goods and services would continue to be a problem, small businesses would otherwise be able to arrive at their income by adding up their bank deposits for the year. Any timing advantage to businesses from not being subject to the judicial doctrines just mentioned would be minimal given that small businesses cannot, as a practical matter, defer recognition of cash by more than a few months without creating severe cash flow problems for the payment of their own bills. The complexity of the judicial doctrines does not warrant their application to small businesses.

SCM offers even greater simplification for the determination of deductible expenses. Under SCM, all current expenditures, including those for the acquisition or construction of inventory, would be deducted when paid. Although a technical violation of GAAP's matching principle of accounting, GAAP is not a particularly useful concept in measuring the ability of a small business to pay tax, or even stay in business. More than one small business that had a profit under GAAP has failed because of cash flow problems. Allowing for the immediate deduction of the cost of inventory simplifies small business record keeping at relatively little cost to the government. For a small business to stay in business, inventory paid for and deducted in one year likely will be sold no later than the next year to ensure sufficient cash flow for business operations. Also, permitting the expensing of inventory before its sale recognizes the fact that by the IRS's own admission, small businesses are not following the rules for the computation of cost of goods sold, in that audits reveal more than 50 percent of cost of goods sold calculations are incorrect.

Finally, permitting the immediate expensing of depreciable property simply continues 100 percent bonus depreciation approach for acquired property with a useful life in excess of one year and the current section 179 expense allowance for purchased depreciable property. Thresholds and limitations similar to the present $10,000,000 limitation for uniform capitalization rules and the current IRS allowance for the cash method may be adopted to restrict SCM to small businesses. Exhibit 1 compares the treatment of many items under the current cash and accrual methods with the SCM.

With a $10 million threshold for the general adoption of the cash method coupled with an election to adopt the SCM, simplification would be available to approximately 99% of all businesses in the United States, thereby reducing the tax compliance burden for almost every person owning and operating a business in America.

IV. Conclusion

The cash method of accounting is undeniably simpler than the accrual method of accounting. Expanding the number of businesses eligible to use the cash method by substituting the current statutory limits on its use with a $10 million gross receipts threshold would benefit not only small businesses but the overall economy.

In addition, codification of the SCM would reduce the tax record keeping and compliance burdens faced by small businesses even further and improve the ability of small businesses to maintain their own accounting records and prepare their own tax returns eliminating the need to retain expensive tax professionals. Such a reduction in the reliance on tax accountants and lawyers will foster a greater appreciation by average Americans that the tax law is not benefitting only special interests but is, in fact, attempting to measure a business's true economic net income. In short, I believe that a simplified cash method of accounting such as the SCM will improve tax compliance at lower cost to businesses with little or no loss of tax revenue.

Thank you for the opportunity to testify today. I welcome any questions from any Member of the Committee or its staff.

Exhibit 1: Comparison of Cash, Accrual and SCM Accounting Methods

Income or Expense Item	Cash Method	Accrual Method	SCM
Income recognition	Actually or constructively received.	Earned under the all-events test.	Actual receipt
Prepaid rental and interest income	Taxable on receipt.	Taxable on receipt.	Taxable on receipt
Prepaid income for services	Taxable on receipt.	Taxed when earned or in the following year of receipt if not earned by end of year of receipt.	Taxable on receipt
Prepaid income for goods	Taxable on receipt.	Taxed on receipt but deferral election allows taxation when earned.	Taxable on receipt
Deduction recognition	Deduct when paid.	Deduct under all-events test and economic performance test.	Deduct when paid
Expenditures for tangible assets with a useful life more than one year	Capitalize and apply cost recovery.	Same as cash method.	Deduct when paid
Prepaid business expenses	Immediately deductible unless contract period exceeds 12 months or extends beyond the end of the next taxable year.	Same as cash method but use economic	Deduct when paid.
Prepaid interest expenses	Not deductible until interest accrues.	Same as the cash method.	Deduct when paid.
Bad debt expense	Not deductible	Deduct under direct write-off method.	Not deductible
Inventory	Capitalize	Same as cash method.	Deduct when paid
Business start-up expenses	Deduction limited to $5,000 then amortize	Same cash method.	Deduct when paid
Section 179	Deduction limited to $500,000	Same as cash.	Deduct when paid
Materials, supplies, improvements	Capitalize or deduct	Same as each	Deduct when paid

Testimony of

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Committee on Small Business

Subcommittee on Economic Growth, Tax and Capital Access

United States House of Representatives

Hearing on

Cash Accounting: A Simpler Method for Small Firms?

July 10, 2014

Chairman Rice and Members of the Committee, thank you for the opportunity to testify on Cash Accounting: A Simpler Method for Small Firms?

My name is Sarah Windham. I am a Senior Tax Manager in the Charleston, South Carolina office of Dixon Hughes Goodman LLP. With over 1,800 people located throughout the region, we are the largest CPA firm based in the Southern United States. Our commitment to our clients' success has led to the development of specialized practice groups, each dedicated to a specific industry and offering comprehensive solutions. One of the firm's professional service areas is Agribusiness. With nearly 60 years of experience serving the agribusiness industry, Dixon Hughes Goodman has developed a deep understanding of the operations and issues affecting various agribusinesses such as food processors, growers, industry associations, cotton ginners and co-ops.

I am a Certified Public Accountant with 15 years of experience. I have extensive experience with agriculture clients, construction and real estate clients, as well as many other small businesses.

I am here today on behalf of the South Carolina Farm Bureau. The South Carolina Farm Bureau is a grassroots, non-profit organization celebrating and supporting family farmers, locally grown food and our rural lands throughout legislative advocacy, education and community outreach.

I am testifying before you today on the potential negative ramifications of the various proposals in Congress that would eliminate, for many taxpayers, the use of cash accounting for the purpose of calculating income tax liability. These adverse effects include a significant increase in the time dedicated to tax compliance, which

will deter farmers and other small business owners from focusing on making a living, as well as, an increase in the cost of tax compliance that would reduce the profitability of many farmers and small businesses who already work with very thin margins. Another effect would be a significant acceleration of tax liability without the cash available to pay the taxes on uncollected, yet taxed, income. These adverse effects would fall disproportionately on small businesses, such as farmers and professionals engaged in the fields of law, accounting, engineering, architecture, health, actuarial science, performing arts, or consulting.

Almost all farmers use the simple, straightforward cash method of accounting in which income is not recognized until cash or other payment is actually received and expenses are not taken into account until they are actually paid. This method is used in determining profitability because it most accurately reflects the true financial picture of a farming operation. Currently the tax code (Internal Revenue Code Section 446) recognizes that to require a separate method of accounting solely for calculating income tax liability is an unnecessary burden and states that income tax liability "shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Section 446 goes on to specifically provide that the cash method is a permissible method of calculating tax liability.

Many taxpayers today, especially small businesses, find complying with the Internal Revenue Code burdensome. The cost of tax compliance for small businesses is 67% higher than that of a large business according to the National Federation of Independent Business. Agriculture is an industry that would be negatively impacted by the proposed changes to require accrual basis accounting. Farms, regardless of acreage, are perfect examples of small businesses. The definition of a small farm has changed dramatically due to advances in science and technology. According to the USDA, in 1945, 100 bushels of corn was produced on 2 acres of land. In 2002, that same 100 bushels of corn were produced on less than 1 acre. As you can see, fewer farmers produce more food on less acreage meaning many family farms may have larger gross revenue but not necessarily larger profits. The gross receipts thresholds proposed for accrual accounting would increase the cost of a family farm's compliance burden in an industry that is facing over increasing input costs each year. Our nation may see further rises in our food prices passed along to the consumer by these growers.

Why cash accounting? Cash accounting is a simple method of record keeping. As illustrated in its most simple and basic definition, the differences between cash versus accrual accounting is a matter of timing. For example, if Farmer Brown sold a bushel of corn in November with the understanding that he would be paid in January, under the cash method, Farmer Brown would record the payment in January when he received payment from his customer. Any expenses associated with growing and preparing the corn for market would be recorded when Farmer Brown paid his suppliers. This method is not dissimilar to maintaining and reconciling a simple checking account.

Most farmers do not employ professional accountants or bookkeeping staff. Many farming operations are in rural communities that do not have a large population from which to draw high level CFOs, controllers or even accountants. Many farms' books and records are maintained by a family member or the farms' owners themselves. They are already saddled with the burden of hiring professionals to prepare payroll and tax returns as well as financial statements. Requiring them to switch to accrual basis would force them to hire bookkeeping assistance and/or spend additional funds on accrual accounting systems, thus creating additional costs in an industry facing rapidly rising production expenses. The simplicity of the cash accounting method can also offer a ready window into tracking cash on hand and current profitability. One story I would like to share with you reflects the financial strain accrual accounting can put on farms. One of our farm clients was being asked by his financial institution to provide accrual basis financial statements on a quarterly basis. As with most farms, they keep their records on the cash basis. After explaining the additional fees the farmer would incur to have us assist their staff in converting the books to accrual basis it was agreed that cash basis statements were a better option.

Farmers by nature must manage risk and volatility. It's endemic to their industry. They are literally at the mercy of nature, the effects and aftermath of weather, and commodity prices. "Whether caused by unpredictable weather that affects crop yields or uncontrollable markets that set the price of goods sold, it is not uncommon for farmers and ranchers to have years with little or no taxable income," Farm Bureau wrote to Senate Finance Committee Chairman Max Baucus (D-Mont.) and Ranking Member Orrin Hatch (R-Utah). Since their income can fluctuate widely from year to year, accrual accounting, coupled with our progressive tax system, would likely cause farmers to pay more taxes over time than a company in a different industry with stable income over the same time period. Cash accounting allows them to accelerate expenses or defer income giving farms the option to even out their taxable income comparable with long-term earnings of other industries. This also gives then the ability to plan for capital investments and the large purchases of inputs based on improved cash flow without incurring debt.

Most farmers and ranchers consider themselves to be small operations. Their operations are often divided into multiple businesses where some family members operate the farm while other family members may operate a related business, such as a processing facility or a retail market. Often times the farm may not have high gross receipts compared to the related business. Some proposals would decrease the threshold for switching to accrual accounting from $25 million to $10 million of gross receipts for C corporations and would also apply to S corporations, partnerships and sole-proprietorships that currently do not have a gross receipts limitation. Under the aggregation rules, the related businesses under common control would be combined. When combined, each of these related businesses, including the farm, would be required to use the accrual method of accounting. Most farms are structured as S cor-

porations, partnerships or sole-proprietorships and would be subject to accrual accounting under these proposals. It may also be argued that the transition from the cash to the accrual method of accounting may be unfair to current owners of an enterprise if the switch to accrual penalizes current owners and compels them to pay for the benefits received by a previous owner.

As stated previously, the differences between cash versus accrual accounting is a matter of timing. Using the same scenario, if Farmer Brown sold a bushel of corn in November with the understanding that he would be paid in January, under the accrual method, Farmer Brown would record the income on his November books even though he's received no money. Farmer Brown also would incur the tax liability on this income even though he's received no money. Though receivables are definitely an asset that is an important measure in determining financial posture, only cash—and not receivables—can be used to pay income tax.

An independent research firm, Informa Economics, revealed that U.S. agriculture producers required to switch from cash-basis to accrual-basis accounting under proposed new laws would have to pay out as much as $4.84 billion in taxes during the next four years. Additionally, borrowing capacity of these operations would decrease by another $7.26 billion over the same time period. According to the study, these farms have less than $1.4 billion in current cash on hand to pay the additional taxes. If the tax proposals associated with cash accounting are effective in an unprofitable farm year or if growers cannot otherwise meet the capital requirements, the farmer may have to downsize to survive. Over 24 million people, or 17% of the US work force, are employed in agriculture industries. The estimated $4.84 billion in tax that would be required to be paid by farms could very easily limit the ability of those farms to hire additional employees or may cause them to lay off employees if they are forced to downsize.

We have many clients that are required to use accrual basis accounting for various reason in the Internal Revenue Code. As I mentioned in my introduction, I also have expertise in the construction industry. I have many examples of clients in this industry that have felt the challenges and burdens of accrual basis accounting. Especially in today's economy, many contractors are experiencing the pains of spending much of their time and effort collecting accounts receivable and managing related cash flow instead of growing their business or building buildings and homes. Many contractors may not receive payment until well after they have invoiced their customers and recorded the income under the accrual method of accounting. Often times, they may be filing tax returns and paying tax on those receivables before the cash has been collected. In a recent experience, a small contractor who I work with has been faced with extending his tax return for several years in a row and incurring penalties and interest until he was able to collect the receivables needed to pay his income taxes. Under the cash basis of accounting, these hardships are less likely to happen since the taxpayer would not pay income tax on the money until it was received.

Summary

The proposed requirement that farm operations use the accrual accounting method for tax purposes introduces complexity and expense to an industry that is already hobbled by gross receipts that do not necessarily indicate an increase in profitability. Producers operate at very low margins, usually under 20%.

After many years in public practice, I believe that the proposals that would require farm operations to use accrual accounting would be determined to the food producers whom it will affect and impact. Under these proposals no additional cash would be available to make tax payments—cash that would otherwise be used to grow business, create more jobs and serve the communities in which businesses operate.

In addition to being a CPA, I am the mother of two small children. The $4.84 billion in taxes that I referenced earlier from the projection made by the independent research firm, Informa Economics, reminds me of the fable I have read to my children—The Goose that Laid the Golden Egg. $4.84 billion dollars is, indeed, a golden egg. Unfortunately, in its pursuit, the forced switch to accrual-basis accounting may kill or do irreparable harm to the very enterprise that feeds the U.S. and the world. Golden eggs can be replaced. The goose, once dead, is gone.

Thank you for allowing me to testify today. I would like to thank Chairman Rice and the other members of the committee who have supported opposing limitations to the use of cash basis accounting. I would be delighted to address any questions from any Member of the Committee or your staff today. I, and others at Dixon Hughes Goodman LLP, would be pleased to address any further questions with you at any future date.

Statement of Terry Durkin, EA

President-Elect National Association of Enrolled Agents

Before the U.S. House of Representatives Committee on Small Business,

Subcommittee on Economic Growth, Tax and Capital Access

July 10, 2014

Thank you, Chairman Rice, Ranking Member Chu, and members of the Subcommittee, for asking me to testify today. I am an enrolled agent (EA) and President-Elect of the National Association of Enrolled Agents (NAEA), which represents the interests of over 46,000 enrolled agents across the country. The enrolled agent license is the highest credential granted by the Department of Treasury. EAs are the only tax practitioners who are directly approved by the Department of Treasury for competency and ethical behavior.

I am also a sole proprietor. My practice is primarily focused on individuals and on small businesses of less than $500,000 gross revenues—what I refer to as "microbusinesses." Today I share with you my perspectives as both a tax practitioner and a small business owner. While I am testifying as an officer of NAEA, the opinions I express in this testimony are mine alone.

Over the years, it has become clear to me that the business checking account is the focal point for most small business bookkeeping. Small businesses use the business checking account to measure cash flow and profits, and to a great extent it is the basis for their tax accounting as well. As a result, any change to the tax law that requires small business owners to move away from simple checkbook accounting, or cash basis accounting, has two negative effects:

1. Increased complexity: Other methods of accounting, for example accrual or hybrid, create complexity by forcing small businesses to track certain expenses and capital outlays separately from their basic income and expense ledgers. For less sophisticated taxpayers, these separate accounting systems can be counter-intuitive and create expensive paperwork requirements.

2. Restricted cash flow: Small businesses are commonly undercapitalized, which results in severe cash flow problems when they make payments but are unable to expense them for tax purposes in the same calendar year. A common complaint I hear in my practice is, "How do I owe taxes when I do not have any cash in my business checking account?"

As Congress begins reforming the tax code, I urge you to keep in mind how essential cash basis accounting is to startup businesses, especially micro businesses. I believe Congress can do more to help them. Both Chairman Camp and former Senator Baucus's

proposals are good first steps, but I strongly recommend that Congress go even further. I have several recommendations:

First, increase expensing under section 179. Because Congress has not enacted legislation to extend expired tax provisions, expensing of capital purchases is currently limited to $25,000. This is a big drop from the $500,000 deduction that was available for the last several years under the provisions that expired. Also, the purchase limit for section 179 property has dropped to $200,000. This, again, is a big drop from the $2,000,000 total purchase limit of the past several years. I have a client in the medical field who is a sole proprietor (single member LLC) and planning to purchase a $100,000 piece of equipment this year. With the current rules, she will not be able to take the whole $100,000 amount as a section 179 expense. Given her situation, she needs to pay estimated taxes to account for the limited expenses she can take this year. However, if she were able to take a section 179 expense on the whole purchase, her tax liability and thus estimated tax payments would be much less. You can see the tax planning challenges we face when taxpayers do not know in advance which provisions might or might not be extended. I urge Congress to increase the section 179 expensing to at least $250,000 and to increase the total purchase limit to at least $1,000,000. Section 179 is essential to creating a true cash basis system for small businesses.

Second, remove uniform capitalization rules for small businesses. The uniform capitalization rules, which were enacted as part of the Tax Reform Act of 1986, require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable. I recommend that Congress consider removing this rule for small businesses and allow them simply to expense these costs.

Third, allow small businesses to use pure cash accounting even if they have inventory. In general, taxpayers must account for inventories if the production, purchase, or sale of merchandise is material to the production of income.

In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period. I recommend that Congress allow small businesses to use pure cash accounting for their operations, even if they have inventory.

Fourth, allow small businesses to expense leasehold improvements. While the current list of tax extenders provides some relief from depreciating improvements to leased property over 39 years, I urge Congress to allow these outlays

to be expensed, under either section 179 or its own specific tax code section. For example, under the currently expired provisions, leasehold improvements were allowed fifteen-year treatment for qualified property. This treatment covers qualified leasehold improvements, retail improvements, and restaurant property. I represent a small business owner that leased part of a building to create a performing arts theatre. He made $300,000 worth of leasehold improvements to the building. Sadly, he did this before consulting anyone and thought he would be able to write off the whole $300,000 in one year since he spent it in that year. Being able to expense these costs in the year spent or at the very least to depreciate the $300,000 over 15 years would be much more palatable and better for his cash flow than depreciating it over 39 years.

Fifth, allow small businesses to deduct all start-up and organizational expenses. A taxpayer may elect to expense up to $5,000 of start-up expenditures in the tax year in which the active trade or business begins. A corporation or a partnership may elect to expense up to $5,000 of organizational expenditures in the taxable year in which the active trade or business begins. I urge Congress to allow all of these costs to be expensed for small businesses. When one of my clients starts a business, he or she inevitably asks, "I spent much more money on the business than I received in income. How can I still owe taxes?" I try to explain that some of the expenses cannot be written off in the year they are expended, even though the client is on a cash accounting system. As you can imagine, this does not go over well for microbusinesses.

Sixth and finally, increase the limit on repairs and improvements. Under rules created by the IRS, smaller businesses that lack an applicable financial statement, such as my microbusinesses, may expense amounts paid for property costing less than $500 rather than depreciating the property over several years. Taxpayers elect this new provision annually by including a statement on the tax return. In addition, taxpayers must have in place appropriate and documented business procedures. Although the idea is a good one, taxpayers must do a lot of paperwork for a small benefit. I would recommend a rule that allowed small businesses to expense these costs in the year made.

I had a client with several rental properties document his intentions to use this new regulation, but his question to me was, "When I buy a washer for the rental unit this year for $600, I cannot take advantage of this new regulation and will have to depreciate it anyway, right? What good is it to have the 'under $500' threshold?" I had to agree with him. He would see more benefits from this regulation if he could expense his $600 washing machine purchase or his $1,000 dryer purchase.

Based on my experience as a small business owner and as a tax practitioner, I believe the above recommendations would substantially simplify operations, ease paperwork burdens, and improve cash flow for many businesses.

In closing, I would like to draw the Subcommittee's attention to the recommendations of President George W. Bush's Advisory Panel of Federal Tax Reform:

> The Panel recommends that most small businesses file taxes the same way they pay their bills—with their checkbook. Under the Panel's options, most small businesses would report income as cash receipts minus cash business expenses. This rule reduces compliance costs by relieving small businesses from keeping a second (or sometimes even a third) set of books for tax reasons and allowing them to use records they already keep for their businesses.

President Bush's panel of experts clearly saw the advantage of simplification and the importance of cash flow for small business owners.

Thank you for your time and attention.

NATIONAL **C**ONFERENCE OF **CPA P**RACTITIONERS

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Mr. Chairman and members of the Committee, thank you for inviting me to testify today. My name is Stephen Mankowski. I am a Certified Public Accountant, member of the American Institute of CPAs and the National Secretary and National Tax Policy Chair of the National Conference of CPA Practitioners, (**NCCPAP**), as well as the Vice President of the Delaware Valley Chapter of **NCCPAP. NCCPAP** is a professional organization that advocates on issues that affect Certified Public Accountants in public practice and their small business and individual clients located throughout the

United States. **NCCPAP** members serve more than one million business and individual clients and are in continual communication with regulatory bodies to keep them apprised of the needs of the local CPA practitioner.

Accompanying me is Mr. Edward Caine, President of **NCCPAP.** We recently merged our practices.

We have been preparing tax returns for over 30 years. Our firm annually prepares well over 1,100 small business and individual tax returns as well as sales tax and payroll tax returns. As a result, we are in the trenches with clients discussing their tax, financial and personal issues, and the impact of events on them. Although our clients are mostly in the Pennsylvania, New Jersey and Delaware area, we have clients in New York, South Carolina, Ohio, Florida, Michigan, Alabama, California, Massachusetts, Nebraska, Tennessee and Washington, DC. In total, our firm files serves clients in over 30 states and also services clients in Canada and Europe. In this respect our practice is the same as many members of **NCCPAP** and other smaller CPA firms throughout the United States.

Discussions surrounding the proper basis of accounting most likely began the moment a second basis was developed. Today, we not only have the two primary bases—cash and accrual—but also others including tax, regulatory and "other". Any basis other than accrual method is referred to as an "Other Comprehensive Basis of Accounting (OCBOA)". For purposes of this testimony, I will be discussing the cash and accrual bases of accounting.

To further complicate the discussion, there are two distinct cash bases of accounting—cash and modified cash. Pure cash presentations in financial statements are very rare because cash receipts would not only include sales receipts but also proceeds from debt and fixed asset sales, and cash disbursements would include expenses, purchases of fixed assets, and loan repayments. This approach does not provide useful or realistic financial statements. Rather, a modified presentation has evolved to address these concerns. Therefore, when the term "cash basis of accounting" is used, the presenter is truly using the modified cash basis of accounting. As such, when discussing the cash basis of accounting, it is really a Modified Cash Basis, but hereinafter will be referred to as "cash basis".

Under the cash basis of accounting, a taxpayer can defer income until cash is received but must also wait to deduct expenses until the amounts have actually been paid. Currently the cash basis of accounting is available for businesses operating as sole proprietors, S Corporations, partnerships that do not have a "C" Corporation as a partner, and personal service corporations (PSCs). A PSC performs activities in the fields of health, law, engineering, accounting, etc. whereby substantially all of the stock of the corporation is owned by employees performing services for the corporation in connection with those activities. In addition, some C Corporations and partnerships with C Corporation as partners can use the cash method if their average annual sales for the previous three years are less than $5 million.

Accrual accounting is considered to be the standard accounting method for most other companies. The accrual method provides a more accurate picture of the company's current financial condition, but its relative complexity makes it more expensive to implement. Generally, a small business that receives income from producing, purchasing or selling merchandise must computer its inventory and use the accrual method of accounting. However, a small business with average annual receipts of $1 million or less can still use the cash method and account for inventory as materials and supplies. The costs of these materials and supplies would be deducted in the year the business sells the merchandise or pays for the items, whichever is later. Resellers with gross receipts of $10 million or less are not required to use the accrual method of accounting.

Currently, if a small business has sales that require an accrual method of accounting or if the business simply wishes to convert from the cash method to the accrual method they must file IRS Form 3115, Application for Change in Accounting Method. The filing of this form is a request for a change in accounting method, not a guarantee. In preparing this form, the taxpayer must take into account any and all changes required to convert to an accrual basis as well as pay a filing fee.

The need for the accrual method arose out of the increasing complexity of business transactions and a desire for more accurate financial information. Selling on credit and projects that provide revenue streams over a long period of time affect the company's financial condition at the point of the transaction. Therefore, it usually makes sense that such events should also be reflected on the financial statements during the same reporting period that these transactions occur.

The form to request a Federal Employer ID number (EIN) requires that an accounting method for the business must be selected. This form is completed prior to the business opening. Often, the primary understanding of accounting and record keeping of the business owner(s) falls under the cash basis of accounting. Throughout their adult lives, as individuals they have received W2s, 1099s, 1098s, and/or real estate bills. All of these documents were prepared under the cash basis of accounting. In fact, almost all personal tax returns are prepared on a cash basis of accounting. Therefore, when opening a business or even purchasing a rental property, the cash basis of accounting is the initial thought that comes to mind for the taxpayer.

In establishing a business, hopefully the business owners have consulted with professionals—attorneys to incorporate the entity, if applicable, and CPAs to ensure the proper business structure. Part of a CPA's job is to ensure that taxpayers comply with the tax codes so that they pay their fair share of taxes. Many business owners went to incorporate their business believing that there are special tax advantages, such as fewer tax audits. They don't realize that there are other considerations including keeping separate books and records, paying themselves a salary as an incorporated business is required to do, additional tax files, and the list goes on.

In recent years, Limited Liability Companies (LLCs) have become a common choice of business structure of the new small business. Often, however, the business owner is not aware of the various tax ramifications. If there is only one owner, the business is taxed as a sole proprietor and all of the business activity will be reported on Schedule C of the owner's individual tax return. With multiple owners, the entity would be taxed as a partnership. The entity can elect to be taxed as an S-Corporation regardless of the number of owners provided that none of the owners are corporations. Under the rules of S Corporations, owners with greater than a five percent ownership interest are required to draw reasonable compensation in the form of a salary where the tax withholdings can be sufficient to remove the burden of making quarterly estimated tax payments as individuals.

Regardless of whether the entity is taxed as an S corporation or partnership, the owners are subject to pass-through income based upon their ownership interest or partnership agreement. Often, this income relates to fund that are not always immediately available for distribution to the owner(s), which may be another challenge to taxpayers who have to follow accrual based accounting as this may trigger phantom income. Owner(s) may choose to keep the net income in the business to help fund expansion, debt service or unpaid bills. Countless times during tax season after the owner(s) receive Form K-1 from their partnership or S corporation, we have to explain to business owners why they are paying taxes on business income that they have not received. This is what is referred to as pass-through income of the business and is taxed at the individual level—frequently at lower tax rates than if taxed at corporate levels. Further complicating pass-through income is the fact that most partnership income is also subject to self-employment taxes.

Many small businesses still operate under the cash basis for tax purposes but opt to prepare accrual basis financial statements, as this **MAY** show them in a better financial position. This is often the case when there is a need for financing. In addition, many banks prefer an accrual basis as it provides them a more comprehensive view of the financial position of the entity because of the inclusion of accounts receivable and accounts payable in the financial statements.

Often business owners do not have the accounting background to properly and adequately track and report revenue and expenses in any manner other than cash basis without the assistance of CPAs, EAs, accountants and bookkeepers. Many owners simply think on the basis of cash in and cash out and give their accountants their bank statements, check stubs and invoices to prepare their financial books which are used solely to prepare their tax returns. Many small business owners do not have systems in place to fully track accounts receivable or accounts payable. Once the financial activity is recorded, small business owners would then need to adjust these statements into an accrual basis. These adjustments can include uncollected revenue, unpaid payroll and related liabilities, prepaid expenses, inventory, etc. Not only will the owners be responsible

for knowing what adjustments need to be made, they also must be able to determine the valuation of these adjustments.

Despite the business owner's reliance on accounting professionals, the fiscal responsibility still falls on the owners. The business owners are and will remain responsible for all of the information that appears on their tax returns. The fact that their tax returns are professionally prepared does not alleviate the taxpayer responsibility for the accuracy of the data contained in the tax returns, but many business owners may not have the financial background to make this determination using the accrual basis of accounting.

If small businesses were required to convert their accounting method to the accrual basis, the overall impact might simply be a "one-time" hit. Meaning, once the conversion is complete, the annual effect might not be as significant as one might expect. The "one-time" hit, however, could be very significant depending on the business. Newer entities or entities with minimal accounts receivable or accounts payable would likely have a small tax increase and possibly even a tax decrease. Entities with a larger receivable base, however, would not be so fortunate. To properly convert, they would need to report **ALL** open receivables as current income and all unpaid bills as current expenses. The impact of this added income could propel the owners into higher tax brackets, which in turn could lead to the phase-outs of itemized deductions and personal exemptions, phase-outs of other deductions and credits including tuition and student loans when the increased income is reported on their individual income tax returns. In addition, taxpayers may find themselves subject to the 3.9% Net Investment Income surtax that became effective last year.

These tax increases will not just affect the taxpayer's federal income tax. Rather, additional state and local taxes may also be due because state and local tax returns usually have to be filed on the same basis as the federal tax returns. Further, many municipalities also impose a tax on gross receipts of all businesses.

As discussed throughout the testimony, taxpayers often are unaware of the differences in accounting methods. If they were required to convert, this obviously creates a major business opportunity for CPAs, EA, bookkeepers, etc. Unfortunately, this will also open the door for unregulated preparers to take advantage of unknowing taxpayers and utilize creative accounting.

Over the last few years, I have attended many IRS meetings, including National Public Liaison (NPL) and Working Together Forums. If there is one common thread that has been resonating from the IRS, it has been to reduce taxpayer burden. While this can mean many things, ultimately I believe that the IRS realizes that business and taxes in today's economy have gotten even more complicated. The current tax codes makes compliance even more complicated. In working to reduce the tax compliance burden, the IRS representatives have stressed the importance of e-Filing tax returns and have improved upon this every tax season, added additional features to their website such as "where's my amended return" that allows taxpayers to track the processing of amended tax

returns. Further, discussions have also centered on what can be done to ease the stress of taxpayers from regular tax filings and to respond to IRS notices that are sent. Requiring taxpayers to change their accounting methods without any specific reasons would truly be in conflict to what the IRS has been working to achieve.

In conclusion, after reviewing the facts surrounding the differences between cash and accrual basis accounting, I feel that the use of cash basis for small firms remains of great importance and should be continued. It is a method that is consistent with how the owners have been taxed throughout their lives on their personal tax returns and how they realistically live. Converting to an accrual basis would add an additional burden onto them—financial. They would need to retain accounting professionals to guide them in this process. The Federal Government would achieve what can best be described as a "one-time" boost of tax revenue from the conversion. Taxpayers would be paying taxes on net income that neither they nor the business has received and this tax increase will include federal, state and local taxes. If the taxpayer has uncollectable aged accounts receivable, the taxpayer will be able to then write off this revenue and potentially send cancellation of debt notices (a 1099C) to those who owe money to the business. If the business subsequently pays the old accounts receivable, the income would be reported at that time and a method would have to be developed to reverse the cancellation of debt notice. The end result would be that the taxpayer has reduced his or her tax burden and the effect of the conversion to accrual basis is further diminished.

All businesses have the opportunity to elect to track their accounting on an accrual basis. Not all have the opportunity to account on a cash basis. Some larger entities and many of those with inventory are required to account on an accrual basis. However, the majority of businesses are permitted to choose their accounting method. With the guidance of financial professionals, they are able to elect the most appropriate accounting method for their specific business. Forcing a business to use the accrual basis not only complicates their business but also requires the owners to take time away from operations to focus on changing an accounting method. Ultimately, one does not start a business to focus on accounting. Forcing this change will do just that.

Thank you for the opportunity to present this testimony.

AMERICAN BAR ASSOCIATION

Governmental Affairs Office

STATEMENT OF

WILLIAM C. HUBBARD

PRESIDENT-ELECT OF THE AMERICAN BAR ASSOCIATION

submitted to the

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

of the

COMMITTEE ON SMALL BUSINESS

of the

UNITED STATES HOUSE OF REPRESENTATIVES

concerning

"CASH ACCOUNTING: A SIMPLER METHOD FOR SMALL FIRMS?"

July 10, 2014

1050 Connecticut Ave. NW, Suite 400 • Washington, DC 20036
www.americanbar.org

Mr. Chairman and Members of the Subcommittee:

My name is William Hubbard, and I am the President-Elect of the American Bar Association ("ABA") and a partner at Nelson Mullins Riley & Scarborough LLP in Columbia, South Carolina, where I practice in the area of business litigation. On behalf of the ABA, which has almost 400,000 members, thank you for the opportunity to express our views regarding the advantages of the traditional cash method of accounting utilized by most law firms, as well as our concerns over draft legislation prepared by House Ways & Means Committee Chairman Dave Camp (R-MI) that would substantially limit the continued use of cash accounting. We request that this statement be made part of the hearing record.

The proposed legislation, contained in Section 3301 of Chairman Camp's draft "Tax Reform Act of 2014," would impose substantial new financial burdens and hardships on many law firms and other types of personal service businesses throughout the country by fundamentally changing the manner in which they must pay their taxes.[1] In particular, the provision would require all law firms and other personal service businesses with annual gross receipts over $10 million to switch from the traditional cash receipts and disbursement method of accounting to the much more complex accrual method of accounting. As a result, many small and medium sized businesses—including many thousands of law firms, accounting firms, medical firms, and other professional service providers—would be forced to pay taxes on income long before it is actually received.

Although we commend Chairman Camp and the Ways & Means Committee staff for their efforts to craft legislation aimed at simplifying the tax laws—an objective that the ABA and its Section of Taxation have long supported—we are concerned that Section 3301 of his bill would have the opposite effect and cause other negative unintended consequences. This far-reaching provision would create unnecessary complexity in the tax law by disallowing the use of the cash method; increase compliance costs and corresponding risk of manipulation; and cause substantial hardship to many law firms and other personal services businesses by requiring them to pay tax on income they have not yet received and many never receive.

While the ABA has expressed its views on many different policy issues during the 113th Congress, this particular issue has become one of the most important issues to our members—and many state and local bars throughout the country[2]—because of the serious negative effects that the proposed legislation would have on practicing lawyers, their law firms, and their clients. In addition, many other leading associations and other entities have expressed serious

[1] The text of the draft "Tax Reform Act of 2014" is available on the House Ways & Means Committee's website at *http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft_0226214.pdf.*

[2] At least 21 state and local bars have expressed opposition to the mandatory accrual accounting legislation, including those in Delaware, Illinois, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Mississippi, Nebraska, New Jersey, North Carolina, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, and Wisconsin. A complete list of the national, specialty, state and local bars opposing the proposal and other resources on this issue are available at: *http://www.americanbar.org/advocacy/governmental_legislative_work/priorities_policy/independence_of_the_legal_profession/mandatory-accrual-for-law-firms.html.*

concerns regarding this and other proposals to impose substantial new limits on the use of cash accounting.[3] Therefore, the ABA appreciates this Subcommittee's efforts to highlight the benefits of cash accounting and the very serious effects that mandatory accrual accounting would have on law firms and many other types of small and medium sized businesses throughout the nation.

Advantages of the Cash Method of Accounting

Under current law, businesses are permitted to use the simple, straightforward cash method of accounting—in which income is not recognized until cash or other payment is actually received and expenses are not taken into account until they are actually paid—if they are individuals or pass-through entities (e.g., partnerships or subchapter S corporations), or their average annual gross receipts for a three year period are $5 million or less. In addition, all personal service businesses—including those engaged in the field of law, accounting, engineering, architecture, health, actuarial science, performing arts, or consulting—whether organized as sole proprietorships, partnerships, limited liability companies, or S corporations, are exempt from the revenue cap and can use the cash method of accounting irrespective of their annual revenues, unless they have inventory.

Partnerships, S corporations, personal service corporations and other pass-through entities favor the cash method because it is simple and generally correlates with the manner in which these business owners operate their businesses—i.e., on a cash basis. Simplicity is important from a compliance perspective because it enables taxpayers to better understand the tax consequences of transactions in which they engage or plan to engage. In this regard, simplicity helps to mitigate compliance costs—which already are significant—and to improve compliance with the Tax Code.

In addition to promoting simplicity, the cash method of accounting also produces a sound and fair result because it properly recognizes that the cash a business actually receives in return for the services it provides—not the business' accounts receivable—is the proper measure of its true income. While accounts receivable clearly are important in determining the overall financial condition of the business and assessing its future prospects, they do not accurately reflect what is available for the business' owners to spend (or their present ability to pay taxes on their income). If the tax rules are changed to disconnect cash collections from how income is taxed, the very business model upon which many law firms and other personal service business operate will be turned on its head.

[3] The ABA has been working in close cooperation with a broad and diverse coalition of organizations including the American Institute of CPAs, American Council of Engineering Companies, American Dental Association, American Farm Bureau Federation, American Institute of Architects, American Association for Justice, Americans for Tax Reform, and over 50 law firms, accounting firms, and other entities in an effort to raise awareness of the proposed mandatory accrual accounting legislation and its unintended harmful consequences.

Mandatory Accrual Accounting for Personal Service Businesses Would Be a Major Change to Current Law and Would Increase, Not Decrease, the Complexity of the Tax Code

Section 3301 of the Chairman Camp's draft legislation would dramatically change current law by raising the gross receipts cap to $10 million while eliminating the existing exemption for law firms and other personal service businesses and for other partnerships and S corporations. Therefore, if this proposal is enacted into law, all law firms and other personal service businesses with annual gross receipts over $10 million would be required to use the accrual method of accounting, in which income is recognized when the right to receive the income is present and expenses are recorded when they are fixed, determinable and economically performed, both aspects of which present complications.

Although Chairman Camp's proposal would allow certain small business taxpayers with annual gross receipts in the $5 million to $10 million range to switch to—and thereby enjoy the benefits of—the cash method of accounting (a concept that the ABA does not oppose), the proposal would significantly complicate tax compliance for a far greater number of small business taxpayers, including many law firms and other personal service businesses, by forcing them to use the accrual method of accounting.

For example, while law firms using the cash method of accounting simply pay taxes on the income that they actually receive, law firms that are required to use the accrual method will be forced to calculate and then pay taxes on multiple types of accrued income, including work in progress and other unbilled work, accounts receivable (where the work has been done and billed but not yet paid for), and accounts paid (where the work has been done, billed, and paid for).[4] In order to meet these requirements, law firms and other affected businesses will need to keep much more detailed work and billing records and hire additional accounting and support staff. As a result, the proposal would substantially raise compliance costs for many law firms and other personal service businesses while greatly increasing the risk of noncompliance with the Tax Code.

Other ABA Concerns Regarding the Legislation

In addition to creating unnecessary complexity and compliance costs, Chairman Camp's proposal would lead to economic distortions that would adversely affect all personal service businesses that currently use the cash method of accounting and those who retain them, including many law firms and their clients, in several ways.

[4] For a detailed discussion of the specific effects that mandatory accrual accounting legislation would have on law firms, *see* PwC's Law Firm Services, *Congressional Proposals Requiring Law Firms to Report Taxable Income on the Accrual Method of Accounting* (December, 2013), available at: *http://legaltimes.typepad.com/files/cash-to-accrual-white-paper.pdf.*

First, the proposal would impose substantial new financial burden on many thousands of personal service businesses throughout the country—including many law firms—by requiring them to pay taxes on income they have not yet received and may never receive. Unlike the current law, where law firms and other personal service businesses need only pay taxes on income they have actually received, the proposal would require many of these firms to pay tax on "phantom income" that they have not yet received, including work in progress, other unbilled work, and accounts receivable. As a result, many firms would have to borrow money or use their scarce capital just to pay their accelerated tax obligations. In either event, the proposal would impose a serious financial burden and hardship on many of these firms.

Second, the proposal would cause the legal profession to suffer even greater financial hardships than other professions because many lawyers and law firms are not paid by their clients until long after the work is performed. Many types of lawyers—such as business lawyers working on complex transactions and litigators involved in lengthy trials or appeals—often are not paid until the end of the case or project, which can be years after the work is performed. This sets lawyers and law firms apart from many other types of professionals—such as doctors, dentists, and accountants—who typically work on a pay-as-you-go basis. Therefore, requiring personal service providers to pay taxes on income that has accrued but not yet been received will create special hardships for many in the legal profession.

The proposal also would disproportionately affect professional service providers that practice in regulated professions, like lawyers, because many of these professionals are subject to special rules that significantly limit their ability to raise capital. For example, lawyers must comply with state court ethics requirements that generally prohibit them from forming a law firm partnership with a non-lawyer [5] or allowing a non-lawyer to own any interest in a law firm partnership.[6] As a result, many law firms must be capitalized solely by the individual lawyers who together own those firms and they are unable to raise equity capital from outside non-lawyer investors. Therefore, forcing these law firms to pay tax on income that has not yet been received and which may never be received could place a major strain on lawyers' ability to properly capitalize and operate their firms.

Third, the mandatory accrual accounting proposal could adversely affect clients, interfere with the lawyer-client relationship, and reduce the availability of legal services in various ways. Under the traditional hourly billing model followed by many law firms, in-

[5] Rule 5.4(b) of the ABA Model Rule of Professional Conduct ("ABA Model Rules") provides that "a lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law." *See also* Charts Comparing Individual Professional Conduct Rules as Adopted or Proposed by States to ABA Model Rules, available at *http://www.americanbar.org/groups/professional_responsibility/policy.html.*

[6] ABA Model Rule 5.4(d)(1) provides that "a lawyer shall not practice with or in the form of a professional corporation or association authorized to practice law for a profit, if...a nonlawyer owns any interest therein, except that a fiduciary representative of the estate of a lawyer may hold the stock or interest of the lawyer for a reasonable time during administration." Similarly, in many states, accounting firms may not have any passive (i.e., investor) ownership and a majority of the owners must hold active CPA licenses.

dividual lawyers within the firm typically perform any necessary legal services for the client throughout the month and the firm then bills the client on a monthly (or quarterly, or some other periodic) basis. In other cases, law firms may agree to handle a client's case on a contingency fee basis, in which a fee (typically a percentage of the total recovery, plus actual expenses) is only charged if the client prevails. In still other cases, a law firm may agree to represent a start-up company in return for an equity interest in the new business instead of a traditional legal fee. Many law firms also agree to represent a certain number of indigent clients on a pro bono basis in which no fee of any kind is charged.

Unfortunately, if the proposed legislation is enacted and many law firms that currently use the cash method of accounting are forced to use the accrual method and pay taxes on income they have not yet received, the resulting financial pressures will force many firms charging on an hourly basis to collect their legal fees immediately after the legal services are provided to the clients (or at least much sooner than they currently do). In addition, many firms will no longer be able to represent as many accident victims, start-up companies, or other clients on a contingent fee basis as they currently do because the taxes on contingent fee income could become due once the court judgments or settlements become final, even if the firm does not actually collect the income for months or even years later. Perhaps worst of all, the serious cash flow and other financial pressures caused by the acceleration of their tax liabilities will force many firms to reduce the amount of free, pro bono legal services that they currently provide to the poor.

Finally, the ABA opposes the mandatory accrual accounting proposal because it would constitute a major tax increase on small and medium sized businesses and would discourage economic growth. According to the Joint Committee on Taxation, the accrual accounting mandate in Section 3301 of Chairman Camp's bill would generate $23.6 billion in new taxes over ten years [7] by requiring the affected businesses to pay taxes on phantom income up to a year or more before it is actually received (if it is ever received). Because this acceleration of a firm's tax liability would be permanent and continue year after year, it would constitute a major permanent tax increase for the firm, when compared to the taxes the firm currently pays under the cash method, until the firm eventually dissolves, merges with another firm, or otherwise ceases to exist.

In addition, the proposal would discourage professional service providers from joining with other providers to create or expand a firm, even if it made economic sense and would benefit their clients, because4 it could trigger the accrual accounting requirement in the bill. For example, solo practitioner lawyers would be discouraged from entering into law firm partnerships—and many existing law firms would be discouraged from growing or expanding—because once a firm exceeds $10 million in annual gross receipts, it would be required to switch from cash to accrual accounting, thereby accelerating its tax payments. Sound tax policy should encour-

[7] See Tax Reform Act of 2014 Discussion Draft, Section-by-Section Summary at page 88, available at: *http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf*

age—not discourage—the growth of small and medium sized businesses, including those providing personal services such as law firms, especially in today's difficult economic environment.

Conclusion

In sum, while the simple cash method of accounting more accurately reflects the true income of most businesses and offers many other advantages, mandatory accrual accounting proposals such as Section 3301 of the draft Tax Reform Act of 2014 would likely cause numerous harmful unintended consequences. These include unnecessary new complexity in the tax law, increased compliance costs, and significant new financial burdens and hardships for the many law firms and other personal service businesses throughout the country that will be required to pay tax on phantom income that has not yet been received and may never be received. In addition, the proposal would harm the economy and discourage growth, without providing any corresponding benefits.

To avoid these harmful results, the ABA urges you and your colleagues to protect the ability of personal service businesses to use the simple cash method of accounting and to oppose provisions like Section 3301 that would require many of these businesses to utilize the more complex and costly accrual method of accounting.

Thank you again for the opportunity to express the ABA's views on this important issue.

ACEC
American Council of Engineering Companies
100 Years of Excellence

House Small Business Committee
Subcommittee on Economic Growth, Tax, and Capital Access
Cash Accounting: A Simpler Method for Small Firms?
Statement for the record of the
American Council of Engineering Companies

July 10, 2014

The American Council of Engineering Companies (ACEC)—the business association of the nation's engineering industry—is pleased to submit this statement to the Subcommittee on Economic Growth, Tax, and Capital Access of the House Small Business Committee for its hearing on the cash method of accounting.

ACEC members—numbering more than 5,000 firms representing hundreds of thousands of engineers and other specialists throughout the country—are engaged in a wide range of engineering works that propel the nation's economy, and enhance and safeguard America's quality of life. The Council represents engineering businesses of all sizes, from those with a single professional engineer to firms that employ tens of thousands of professionals working in the United States and throughout the world.

A proposal is being discussed in Congress that would change the rules regarding the use of the cash method of accounting. The Tax Reform Act of 1986 requires most businesses, particularly those that have inventories, to use the accrual method of accounting. However, professional services firms of all sizes, including engineering firms, are generally allowed to use cash accounting for tax purposes, either under the QPSC exception or because they are organized as S corporations or partnerships. In addition, the law provides a general allowance in the use of cash accounting for any small firm with revenues below $5 million, as well as farmers.

The proposal under consideration would change these long-standing rules and limit the use of cash accounting only to sole proprietorships and firms with less than $10 million in gross receipts. While increasing the basic small firm threshold from $5 million to $10 million makes sense, the larger impact of forcing engineering firms with revenues over $10 million to switch to accrual accounting presents major problems.

At the outset, we would note an immediate contradiction in policy, as the current small business size standard for engineering firms is $14 million. Should the proposal become law, some firms that are classified as small by the Small Business Administration would be considered large under the Internal Revenue Code.

The proposal presents more fundamental problems, however. Engineering firms normally carry large balances of accounts receivable and work in progress, representing work performed for clients for which they have not yet been paid. The primary cost for engineering firms is labor, and approximately 85 percent of a typical firm's expenses can be attributed to payroll, benefits, and similar regular expenses. Engineering firms generally have to wait at least 120 days to be paid for services rendered to their clients, and at the same time must pay their employees every two weeks. While this situation can create cash flow challenges for firms, the use of cash accounting helps to mitigate those challenges by allowing firms to make tax payments after receiving payment for their services.

By contrast, forcing firms to switch to accrual accounting would require firms to use debt financing to cover the delta between expenses and receipts, which is much harder for small and mid-size firms to access today. The cash flow challenges that would result

from a switch to accrual accounting would create additional negative consequences, including workforce downsizing among some firms, delayed expansion plans, and decreased shareholder distributions. In fact, many S corporations utilize shareholder distributions to facilitate ownership transition, and any reduction could have a detrimental impact on a firm's long-term viability. All of these outcomes would take money out of the productive economy, jeopardize well-paying jobs, and burden firms that continue to struggle in the soft economy.

The simple premise of cash accounting allows engineering firms to pay income taxes on their revenue when they are actually paid, rather than when they submit an invoice. Conversely, they are not allowed to take deductions for expenses when they are incurred, but when the expense is actually paid. Once again, we believe this approach is fair for an industry whose product is intellectual capital, not hard physical inventory.

For these reasons, ACEC strongly recommends that Congress continue to allow engineering firms and other similar businesses to use cash accounting as they have done for decades.

On behalf of the nation's engineering industry, we thank the Subcommittee on Economic Growth, Tax, and Capital Access of the House Small Business Committee for the opportunity to submit a statement on this important issue.

AICPA®

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

July 17, 2014

The Honorable Tom Rice
Chairman
Subcommittee on Economic Growth, Tax and Capital Access
U.S. House Small Business Committee
2360 Rayburn House Office Building
Washington, DC 20515

The Honorable Judy Chu
Ranking Member
Subcommittee on Economic Growth, Tax and Capital Access
U.S. House Small Business Committee
2360 Rayburn House Office Building
Washington, DC 20515

RE: Hearing on Cash Accounting: A Simpler Method for Small Firms?

Dear Chairman Rice and Ranking Member Chu:

The AICPA respectfully submits the attached written statement for the record of the July 10, 2014 hearing of the Subcommittee on Economic Growth, Tax and Capital Access of the House Committee on Small Business on the cash method of accounting.

The AICPA is the world's largest member association representing the accounting profession, with more than 394,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as America's largest businesses.

We welcome the opportunity to further discuss these comments on the cash method of accounting for small businesses or to answer any questions that you may have. I can be reached at (304) 522-2553, or jporter@portercpa.com; or you may contact Melissa Labant, AICPA Director of Tax Advocacy, at (202) 434-9234, or mlabant@aicpa.org.

Sincerely,

Jeffrey A. Porter, CPA
Chair, AICPA Tax Executive Committee

AICPA®

American Institute of CPAs
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WRITTEN STATEMENT
OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

For the Record of the
July 10, 2014 Hearing
of the

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

on

CASH ACCOUNTING: A SIMPLER METHOD FOR SMALL FIRMS?

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

WRITTEN STATEMENT

For the Record of the

July 10, 2014 Hearing

of the

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

on

CASH ACCOUNTING: A SIMPLER METHOD FOR SMALL FIRMS?

Introduction

The AICPA commends Chairman Rice, Ranking Member Chu, and the Subcommittee on Economic Growth, Tax and Capital Access for examining cash accounting, its utilization by small businesses, and whether the current policies should be changed to allow small firms more flexibility in choice of accounting methods.

We wholly support the expansion of the number of taxpayers that may use the cash method of accounting. The cash method of accounting is simpler in application, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the income being taxed. For these same reasons, we are extremely concerned with, and oppose, any limitations on the use of the cash method for small and service businesses, including those businesses whose income is taxed directly on their owners' individual returns, such as S corporations and partnerships. Requiring these businesses to switch to the accrual method upon reaching a gross receipts threshold would unnecessarily discourage small business growth.

The AICPA is the world's largest member association representing the accounting profession, with more than 394,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on Federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individ-

uals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

Background

1. General Rules

In general, a taxpayer may use any method of accounting that clearly reflects income (including the cash method) unless the taxpayer is required by the Internal Revenue Code or Income Tax Regulations to use a specific method of accounting (e.g., the accrual method of accounting, the percentage of completion method for long-term contracts, etc.).[1]

For example, the following taxpayers are generally permitted to use the cash method of accounting:

1. Sole proprietors;[2]
2. Pass-through entities (e.g., partnerships and S corporations);[3]
3. Entities that engage in a farming business;[4]
4. Entities that primarily perform services by their owners;[5] and
5. Entities that satisfy a $5 million gross receipts test (and do not maintain inventory).[6]

Currently, the Internal Revenue Code and Income Tax Regulations require certain taxpayers to adopt a specific method of accounting (e.g., the accrual method of accounting, the percentage of completion method for long-term contracts, etc.). For example, C corporations (as well as partnerships that have a C corporation as a partner) and tax shelters are not allowed to use the cash method of accounting (subject to exceptions),[7] and a taxpayer must also generally use the accrual method of accounting if the taxpayer purchases, produces, or sells merchandise.[8]

On the other hand, the Internal Revenue Service (IRS), by administrative action, has allowed certain "small" taxpayers (e.g., qualifying taxpayers[9] and qualifying small business taxpayers[10]) to use the cash method even if inventories are maintained.

In other words, most types of entities (e.g., sole proprietorships, partnerships, and S corporations) may use the cash basis method of accounting regardless of whether they maintain inventory, if they have average annual gross receipts of less than $10 million. As mentioned above, this threshold is lowered to $5 million for C corporations.

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[1] See section 446(c).
[2] See section 446(c).
[3] See section 446(c).
[4] See limitation, however, under section 447.
[5] See section 448(b).
[6] See section 448(b)(3).
[7] See section 448(a) and 448(b)(3).
[8] See Treas. Reg. § 1.446-1(c)(2)(i).
[9] According to Rev. Proc. 2001-10, a qualifying taxpayer is an entity with average annual gross receipts for each prior tax year ending on or after December 17, 1998, of $1 million or less.
[10] According to Rev. Proc. 2002-28, a qualifying small business taxpayer is an entity with average annual gross receipts for each prior tax year ending on or after December 31, 2000, of more than $1 million but not more than $10 million, and is not otherwise prohibited from using the cash method under section 448(a).

In general, a taxpayer who changes its accounting method (e.g., from the cash method to the accrual method) is required to compute an adjustment (section 481(a) adjustment) to prevent items of income or expense from being duplicated or entirely omitted from the taxpayer's taxable income. If the accounting method change is made with the permission of the Commissioner and results in a positive section 481(a) adjustment (increase in income), the adjustment is included in taxable income ratably over four taxable years. Whereas, a negative section 481(a) adjustment (decrease in income) is taken into account entirely in the year of change.[11]

12. Recent Proposals

On February 21, 2014, House Ways and Means Committee Chairman Dave Camp released the Tax Reform Act of 2014, which provides that the cash method of accounting is available for natural persons (in other words, "individuals") and any other taxpayer who meets the gross receipts test and is otherwise eligible to use the cash method. Under the proposal, a taxpayer would satisfy the gross receipts test if the taxpayer's average annual gross receipts for a three taxable-year period are $10 million or less. The proposal effectively would require certain pass-through entities (e.g., partnerships and S corporations) and personal service corporations with average annual gross receipts in excess of $10 million to use the accrual method of accounting. The proposal also would provide that a positive section 481(a) adjustment from an accounting change from the cash method to the accrual method is accounted over a four-year stepped period within eight years.

On November 21, 2013, the former Senate Finance Committee Chairman Max Baucus released the 2013 Cost Recovery and Accounting Staff Discussion Legislative Language, which provides that the cash method of accounting is only available by taxpayers who meet the gross receipts test and are otherwise eligible to use the cash method. Under the proposal, a taxpayer would satisfy the gross receipts test if the taxpayer's average annual gross receipts for a three taxable-year period are $10 million or less. The proposal effectively would require certain individuals, farmers, pass-through entities (e.g., partnerships and S corporations), and personal service corporations with average annual gross receipts in excess of $10 million to use the accrual method of accounting. However, the proposal would permit a taxpayer to use the cash basis method of accounting, if the gross receipts threshold is satisfied, regardless of whether it maintains inventory.

In summary, if enacted, these proposals would both expand and limit the availability of the cash method of accounting for small businesses by increasing the gross receipts threshold from $5 to $10 million and requiring pass-through entities and personal service operations with average annual gross receipts in excess of $10 million to use the accrual method of accounting.

Analysis

[11] See Section 481(a); Rev. Proc. 97-27, 1997-1 C.B. 680.

Increased burden in adopting the accrual method of accounting

The AICPA believes that requiring small and service businesses, including those businesses whose income is taxed directly on their owners' individual returns, such as S corporations and partnerships, to adopt and use the accrual method of accounting imposes complexities and increases burden.

Under the cash method, income is recognized when it is actually or constructively received, and expenses are recorded when paid. These are straightforward and easily applied tests. Therefore, determining taxable income using the cash method is much simpler in application. Thus, many small businesses, including the service industry, prefer using the cash method of accounting.

Under the accrual method, income is recognized when the right to receive the income is fixed and the amount is determinable with reasonable accuracy,[12] and expenses are deductible when they are fixed, determinable, and economically performed[13] (e.g., the "all-events test"). These tests require analysis that is more complex than under the cash method. For example, under the accrual method, a taxpayer must determine the fact and amount of liability and determine if the property or service to which the accrual relates is actually provided or used. Therefore, determining taxable income under the accrual method is far more difficult in application, resulting in increases in the cost of compliance compared with the cash method. Thus, many small businesses oppose any requirement that the accrual method of accounting be used.

Given that the cash method remains a far simpler method of accounting, the AICPA believes that simplicity justifies its continued use by non-natural persons (e.g., pass-through entities and personal service corporations), regardless of their gross receipts.

Discouraging business growth

The AICPA believes that limiting the use of the cash method of accounting by businesses (e.g., sole proprietors, farmers, and pass-through entities) would discourage their natural business growth.

Every business hopes to grow. Businesses may grow organically, or by combining with similar businesses. As a result, although many businesses start out as a sole proprietorship, most eventually convert to a pass-through entity (e.g., general partnerships, limited liability partnerships, limited liability companies, and S corporations) to join forces and expand their operations.

Under Chairman Camp's proposal, many pass-through entities would need to change to the accrual method of accounting once their average annual gross receipts exceeded a $10 million threshold, inhibiting both organic growth and growth through combination. For example, assume a sole proprietor is currently operating a successful business with more than $10 million of gross receipts. If the sole proprietor rewards an employee by making the employee a partner in the business, the business is no longer operating as

[12] See section 451.
[13] See section 461.

a natural person (sole proprietor) and therefore, would be ineligible to continue to use the cash basis method of accounting—providing a disincentive to expand the business.

Similarly, if two firms (each with $5.5 million gross receipts) intend to combine to share resources and expertise and better serve their clients, the combined firm would exceed the proposed threshold and be subject to the mandatory use of the accrual method of accounting—again, creating a disincentive to gain efficiencies through combination. In other words, a business's inability to use the cash method of accounting would create an artificial obstacle to joint ventures or the joining of two or more owners or businesses.

In addition, limiting the use of the cash method of accounting would slow down (even stop) business growth. As noted above, requiring businesses to adopt the accrual method would increase the cost of compliance. This increase would force these businesses to stop hiring and planning for future expansions. In other words, instead of these businesses focusing on their growth (e.g., hiring more employees, expanding to new markets), they would be required to shift their resources to comply with the requirement.

Small businesses play a key role to the economic growth in the United States. According to the Small Business Administration, small businesses "accounted for 63 percent of the net new jobs created between 1993 and mid-2013 (or 14.3 million of the 22.9 million net new jobs)." The AICPA believes that small businesses need a sound tax policy and business environment that promotes simplicity and economic growth. The cash method of accounting provides simplification and allows small businesses to focus on their expansion and growth.

Financial burden on individual owners of service businesses

The AICPA believes that limiting the use of the cash method of accounting for service businesses and pass-through businesses would impose an undue financial burden on their individual owners.

These businesses should not be required to use the accrual method of accounting. Such a requirement would accelerate the taxable income of many professional service firm owners (e.g., CPAs, attorneys, engineers), resulting in an increased tax liability on earnings they have not yet received. In order to pay this accelerated tax, some businesses would be forced to make cash distributions to their owners from other sources (e.g., new loans, reduction in workforce, slowing growth initiatives, etc.), potentially threatening their operations due to a tightening of cash flow. Other businesses would force their owners to deal with the financial burden regardless of the individuals' ability to pay.

Additionally, the acceleration of income may result in the only reason that a partner is taxed at a higher marginal tax rate. Under the current U.S. tax system, income is taxed at progressively higher rates.[14] For example, the top marginal rate of 39.6 percent ap-

[14] IRS 2013 Form 1040 Instructions, page 101.

plies to taxable income over $400,000 for a partner filing as a single person. Thus, the acceleration of income of a partner could be taxed at the highest marginal rate that would otherwise be taxed at a lower rate (e.g., 35, 33, 28, 25, 15, or 10 percent). In addition to paying the highest tax rate, the partner could lose some of the benefit of itemizing certain deductions. For example, itemized deductions (e.g., mortgage interest deduction, charitable deduction) of a partner with an adjusted gross income of $250,000 would be reduced by the lesser of 3 percent of the excess of adjusted gross income (AGI) over $250,000 or 80 percent of the itemized deduction.[15] Thus, the partner is likely to have a higher overall tax liability with the acceleration of income.

For those professional service firms that are subject to state regulations limiting ownership to individuals who actively participate in the business, the potential hardship created by restricting use of the cash method by pass-through entities would increase significantly. For example, in many states, a firm engaged in the practice of accountancy is specifically prohibited from allowing any passive (investor) ownership and a majority of the owners must hold active CPA licenses. As a result, many accounting firms must raise capital solely by the individual professionals who together own the firm; they cannot raise capital from outside investors. As a result, an acceleration of tax on income that has not actually been collected in cash would place a strain on the ability of such professional owner-operators to properly capitalize and maintain capital in their firms.

We believe that a transition from the cash to the accrual method imposes undue financial burden and would have a negative impact on both a new owner's ability to finance entrance into a partnership and a firm's ability to grow either independently or through merging with another firm.

Conclusion

The AICPA supports expansion of the number of taxpayers who may use the cash method of accounting. As we have discussed, the cash method of accounting is simpler in application, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the cash.

However, we strongly believe that Congress should not restrict the use of the long-standing cash method of accounting for the thousands of U.S. businesses that rely on it. We have confidence that forcing more businesses to use the accrual method of accounting for tax purposes would increase their administrative burden, discourage business growth in the U.S. economy, and unnecessarily impose financial hardship on cash-strapped businesses.

[15] See section 68(a).

Statement for the Record

Cash Accounting: A Simpler Method for Small Firms?

July 10, 2014

Subcommittee on Economic Growth, Tax and Capital Access

Committee on Small Business

House of Representatives

We, the undersigned, wish to thank Chairman Rice, Ranking Member Chu and Members of the Subcommittee for convening this hearing to examine whether current tax policies should be changed to allow small businesses more flexibility in using the cash method of accounting. We represent a diverse group of service businesses who rely on the cash method to simply and accurately report income and expenses. As Congress examines the merits of the cash method of accounting and considers whether to expand its availability to more small businesses, we urge you to oppose any proposal that would force businesses currently allowed to use the cash method to switch to accrual accounting.

For several decades, Congress has recognized that the cash method is a simple, accurate, and transparent method of reporting when income is received and when expenses are paid. The cash method is used extensively by American service providers representing a wide array of large and small businesses, many family-owned, including medical, dental, accounting, law, architectural, engineering, landscaping, horticultural, financial services, and consulting firms. Limiting the use of the cash accounting method would impose a significant tax and compliance burden on these businesses—and the individuals who own them—and undermine a tried and tested method of measuring and verifying a company's income and expenses.

Under current law, the cash method of accounting may be used by individuals, most farmers, and service providers operating as partnerships, S corporations and professional service corporations, regardless of size. Certain C corporations with gross receipts up to $5 million also may use the cash method. The House Ways and Means and Senate Finance Committees have released tax reform proposals that would allow more businesses with gross receipts up to $10 million to use cash accounting. However, their proposals also would require partnerships, S corporations, and personal service corporations with gross receipts over $10 million to switch from the cash method to the accrual method of accounting; the Senate version also includes individuals and farmers.

While we do not oppose measures expanding the use of cash accounting to benefit the smallest businesses, we do oppose measures that would prohibit us from continuing to use the cash method and

that could result in significant hardship and negative consequences. The cash method is good for all sizes of service businesses with common concerns about economic growth, job creation and competitiveness. Proposals to restrict its use are without any policy justification and are used solely for the purpose of raising revenue to pay for tax reform.

Such proposals would force businesses to switch from a simple "cash-in/cash-out" method of accounting for income and expenses to the much more complicated accrual method of accounting. Further, accrual accounting requires taxpayers to pay tax on accounts receivable and work-in-progress—phantom income that hasn't been collected and may never be collected—creating cash flow issues and forcing some taxpayers to go into debt just to pay their tax bill. Compliance costs would escalate, adding to the already, overwhelming recordkeeping burdens and costs faced by many of these businesses. Ultimately, because most of these businesses are pass-throughs, the cash to accrual proposal is an immediate and unfair tax increase on individuals.

There is no policy justification to force service businesses to switch from cash to accrual accounting. There is no evidence or allegation of abuse of the cash method by the taxpayers who use it. Further, the impact of the proposal is not consistent with the stated principles of tax reform, including fairness, simplicity, certainty, economic growth, job creation and enhanced competitiveness. Indeed, banning a tried and true method of tracking income to arbitrarily pay for tax reform is entirely inconsistent with these principles.

Thank you for the opportunity to provide these comments. We are pleased to serve as a resource to the Congress, the Committee, and the Subcommittee, and we look forward to our continued work together on this important matter.

Adams and Reese LLP
American Council of Engineering Companies
American Institute of Architects
Americans for Tax Reform
Covington & Burling LLP
Cozen O'Connor
Federal Communications Bar Association
Fisher & Phillips LLP
Gardere Wynne Sewell LLP
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July 10, 2014

Rep. Tom Rice (SC-07), Chairman
House Small Business Committee,
Subcommittee on Economic Growth,
Tax and Capital Access
2361 Rayburn House Office Building
Washington, D.C. 20515

Rep. Judy Chu (CA-27), Ranking Member
House Small Business Committee,
Subcommittee on Economic Growth,
Tax and Capital Access
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Rice and Ranking Member Chu,

On behalf of the National Cattlemen's Beef Association (NCBA), the nation's oldest and largest national trade association for cattlemen representing more than 140,000 cattle producers nationwide, I applaud you for holding a hearing today on the use of the cash accounting method for smaller firms. NCBA is producer-directed and consumer-focused and represents all segments of the U.S. beef industry. Our top priority is to produce the safest, most nutritious and affordable beef products in the world. This has been consistent throughout our industry's history and in our long-term efforts to continually improve our knowledge and ability to produce beef products to meet consumer preferences.

As you may know, the U.S. beef industry currently has the smallest herd since the 1950s. Long-term drought, fires and floods have played a major role in the liquidation of our national herd. The tax code is one of the few areas where ranching families and beef operations can seek temporary relief when disaster strikes. Unfortunately, our tax code has grown just as unpredictable as the weather in recent years.

NCBA is supportive of comprehensive tax reform. We believe that a more simple tax code that encourages economic growth is a tool that will give the United States the competitive advantage we need to create more jobs at home and keep the jobs we already have. Some of the tax reform proposals have discussed switching all industries, including agriculture, from using the cash accounting method to the accrual method. The cash accounting method is widely used in the beef industry and we ask that you carefully consider the ramifications of requiring more and more ranching families to switch from cash accounting to accrual accounting.

Cash Accounting vs. Accrual Accounting

According to some of the discussion drafts proposed earlier this year, there should be a fundamental change to a common practice in most agricultural businesses. For instance, under one of the proposed changes agricultural businesses with more than $10 million in gross receipts will be required to shift from the cash accounting method to the accrual method of accounting. Due to uncertain and fluctuating income that results from variable cropping practices, weather conditions, and markets, farmers and ranchers need a tax code that allows them to manage the risks associated with agriculture while complying with tax liabilities under the law. Cash accounting combined with the ability to accelerate expenses and defer income gives farmers and ranchers the flexibility they need to manage their tax burden. Requiring agricultural businesses to shift to accrual accounting could dramatically reduce working capital and equity available for investment in many sectors of the agriculture industry as well as increase complexity and decrease flexibility for many agricultural businesses.

The following example, taken from the Farmers Tax Guide published by the IRS (IRS Publication 225) illustrates the differences between the two accounting methods:

Example 1.

You are a farmer who uses an accrual method of accounting. You keep your books on the calendar year basis. You sell grain in December 2013 but you are not paid until January 2014. Because the accrual method was used and 2013 was the tax year in which the grain was sold, you must both include the sales proceeds and deduct the costs incurred in producing the grain on your 2013 tax return.

Example 2.

Assume the same facts as in Example 1 except that you use the cash method and there was no constructive receipt of the sales proceeds in 2013. Under this method, you include the sales proceeds in income for 2014, the year you receive payment. Deduct the costs of producing the grain in the year you pay for them.

NCBA can provide additional real-world examples of the myriad challenges this proposal poses for agriculture. Simply put, we do not believe that this change is appropriate in a commodity industry with high price volatility, low margins, high capital needs, and low liquidity. Mandates to use accrual basis accounting will pose significant tax liability and eliminate the flexibility agricultural operations need to adjust to ever changing environmental, regulatory, and market conditions. We strongly oppose such mandates.

Also, NCBA is concerned about the unknown ramifications of requiring more beef operations to use accrual accounting instead of cash accounting. For instance, are you aware that cash accounting is a pre-requisite for a rancher to take advantage of disaster relief found in the tax code?

For example, if a producer is forced to sell livestock, in excess of normal levels, due to shortages of water, feed or other consequences of drought, the income tax on the gain from the sale of those animals may be postponed. Producers have two distinct tax options available to them in this circumstance:

1. Code Section 451(e): The election to postpone reporting the taxable gain on the additional sales of any livestock for one year; or

2. Code Section 1033(e): The election to postpone, and altogether avoid, paying taxes on the gain from the sale of breeding, draft, or dairy animals if they are replaced within a specified time frame.

IRC Section 451(e) provides for the one-year postponement of gain on the sale of all classes of livestock. In order to qualify for this election a producer must meet the following criteria:

- Their principal business must be farming.
- <u>They must use the cash method of accounting.</u>
- They can show that under usual business practices, they would not have sold or exchanged the additional animals this year except for the weather-related condition.
- The weather-related condition caused an area to be designated as eligible for assistance by the federal government.

We support efforts of Congress to simplify the tax code in a way that also stimulates the economy. Please understand that cash accounting serves as a tool in the toolbox for farmers and ranchers whose land has provided food and fiber for American families for many generations and, hopefully, will continue to do so for future generations. We ask you to remember America's ranching families, whose wealth is tied up in land that has been taxed annually since it was originally settled and taxed again when transferred at the death of each farmer and rancher who wanted to pass on that legacy to the next generation. We have paid and will continue to pay our fair share of taxes. We simply ask that you carefully consider the ramifications of requiring more and more ranching families to switch from cash accounting to accrual accounting before you move forward. Thank you for your consideration.

Sincerely,

Bob McCan

Bob McCan
President, NCBA

TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

NFIB
The Voice of Small Business®.

Statement for the Record for the

House Committee on Small Business

Cash Accounting: A Simpler Method for Small Firms?

July 10, 2014

National Federation of Independent Business (NFIB)
1201 F Street, NW Suite 200
Washington, DC 20004

The National Federation of Independent Business (NFIB) appreciates the opportunity to submit this statement for the record to the Committee on Small Business for the hearing entitled "Cash Accounting: A Simpler Method for Small Firms?" NFIB is the nation's leading small business advocacy organization representing over 350,000 small business owners across the country, and we appreciate the opportunity to provide our perspective on this issue. NFIB represents small businesses in every region and every industry in the country. Accordingly, NFIB has a unique insight into the concerns of the small business community, and can speak with authority on these concerns.

NFIB applauds the Committee for having this hearing today. Small business' ability to use cash accounting can greatly simplify the time and costs associated with tax preparation by small business owners. But while the availability of cash accounting has been gradually expanded over the years, significant limitations to its availability remain that limit the ability of small business owners to take advantage of this simplified accounting method.

Small Business' Ability to Use Cash Accounting

Cash accounting, when receipts are recorded during the period they are actually or constructively received, and expenses are recorded in the period in which they are actually paid, is the preferred method of accounting for small businesses. Forty-one percent of small businesses report using the cash method of accounting according to a 2006 NFIB National Small Business Poll. Small business owners prefer the cash accounting method because it is much easier for them to follow and more closely matches the way that small business owners maintain their books. However, the availability of cash accounting is not applied evenly by the tax code or the Internal Revenue Service (IRS). Depending on a firm's entity-type, size (by revenue), and industry-type, cash accounting may be unavailable to a number of small businesses.

The Internal Revenue Code (the code) contains significant limitations to the ability of small business' to use cash accounting. Section 448(c) allows C corporations and partnerships with less than $5 million in gross receipts to use cash accounting. This provision, however, does not include S corporations, which are one of the most frequently used types of business entity used by small business owners, Further, any taxpayer who maintains inventories is prohibited from using cash accounting regardless of their gross receipts. This prevents any small business owner who purchases and sells merchandise, such as retailers or wholesalers, from using the cash accounting method. Finally, the code prohibits taxpayers who manufacture goods for resale from using cash accounting.

Since 2000, the IRS has taken meaningful steps to expand the availability of cash accounting to small businesses. IRS Revenue Procedure 2000-22 permits small businesses with gross receipts of $1 million or less (based on the preceding three-year period) to use cash accounting where the business otherwise would have to use accrual accounting because it is required to account for inventories. Revenue Procedure 2002-28 permits qualifying small businesses

with gross receipts of $10 million or less (based on the preceding three-year period) to use cash accounting. However, Revenue Procedure 2002-28 precludes many industries, such as manufacturing, wholesale trade, retail trade and mining. The procedure also does not apply to C corporations or partnerships with a C corporation partner.

Due to these statutory and administrative limitations, many small businesses cannot use cash accounting. Many of these businesses would benefit from an expanded ability to use cash accounting for tax purposes. Permitting more businesses with higher gross receipts to use cash accounting helps small businesses to manage cash flow because it better reflects the business owner's ability to pay taxes. This expansion is also logical given efforts by the IRS to expand the availability of cash accounting.

Allowing any business entity with gross receipts of less than $10 million meaningfully expands the availability of cash accounting for small business owners. Because of the large number of small businesses that maintain inventories, any expansion of cash accounting should also apply to these types of taxpayers.

Conclusion

NFIB greatly appreciates the efforts of the Committee to shed light on the importance of cash accounting for small business owners. Current law is overly complicated and fails to adequately reach many small business owners who might otherwise be able to lower their tax compliance burden. Expanding its availability would go a long way towards simplifying tax compliance and preparation for small business owners. However, expanding cash accounting is just one aspect of tax reform and it does not replace the need to reduce individual tax rates and ensure a level playing field between pass-through entities and C corporations.

Testimony of Jeffrey Wald

Chief Executive Officer, Kennedy and Coe, LLC

To the House of Representatives Committee On Small Business,

Subcommittee on Economic Growth, Tax and Capital Access

Cash Accounting: A Simpler Method for Small Firms?

July 10, 2014

Kennedy and Coe commends Chairman Rice, Ranking Member Chu and the entire House Committee on Small Business for examining the value of the cash method of accounting to U.S. small businesses.

As CEO of Kennedy and Coe, one of the nation's largest accounting firms specializing in food and agriculture businesses, I can tell you first hand that the cash basis of accounting is critical for agriculture.

The agriculture sector, unlike many other sectors of our economy, is still driven by the small and family business. According to USDA's 2012 Census of Agriculture, nearly 88 percent of the 2.1 million farm businesses are considered small businesses. Without question, this makes the agriculture industry among the most reliant on the success or failure of the small business owner.

Kennedy and Coe works with farmers and ranchers in nearly every state. And regardless of region or commodity type, our accountants find that the cash basis of accounting helps small farmers grow their businesses. We see three primary reasons for this:

1. Cash accounting is simpler and requires less administrative work.

2. Cash accounting helps farmers and ranchers manage volatile commodity and input prices; and

3. Cash accounting ensures that taxes do not have to be paid until after income has been received.

While these benefits may be universal among anyone utilizing cash accounting, the impact is particularly acute in the agriculture sector.

Cash Accounting is simpler and requires less administrative work

For those of us in the farming industry, we know just how wrong some perceptions of agriculture can be. Take the idea that our food and fiber comes from corporate farms, for instance. In reality, 97.6 percent of all U.S. farms are family owned and operated. These farms are responsible for 85 percent of all U.S. farm production.

Look a little closer and we get an even clearer picture of just who is growing our food:

-62 percent of farmers in the U.S. are over the age of 55;
-77 percent have worked their land for more than 10 years

Put simply: these operations are not large enough to employ an army of accountants and lawyers capable of navigating a complex tax code. These are family businesses that have to consider the trade-offs of maintaining complex accounting records. Because the more time most farmers spend doing their books, the less time they can spend on their farms and with their families.

What farmers need is a reasonably easy, common sense way to accurately keep track of receipts and expenses. The cash basis of accounting provides just that.

Cash Accounting Helps Farmers Manage Volatile Commodity and Input Prices

The agriculture sector is widely recognized for its slim margins and extreme volatility. But just because these characteristics are inherent, doesn't mean they are easy to deal with.

Running a successful agricultural operation requires constant planning to adapt to wide swings in the cost of critical inputs such as energy, fertilizer, or animal feed.

On the other end of the equation, farm operators need to be prepared for considerable changes in annual production volumes from factors such as weather or disease. They also need to prepare for major shifts in the prices they receive, as things like drought or policy changes can have a major impact on commodity markets.

The cash basis of accounting is the one critical tool that farmers and ranchers can use to deal with this volatility.

Under the cash basis, income is not realized until the business receives payment for its product; and expenses are not realized until that expense is paid. With this flexibility, farm businesses can elect to withhold a portion of their crop until prices improve. Or, they can elect to purchase large volumes of feed or fuel when prices are low, even if it will be used across multiple tax-years.

The value of this flexibility cannot be overstated—this carried inventory or reduced expense is often what makes the difference between making and losing money in a given tax year.

Cash accounting ensures that taxes do not have to be paid until after income has been received.

Due to the commoditization of the agriculture business, and the vast amount of capital it takes to break into the food processing business, many farmers do not sell their products directly into the market. Instead, they sell to intermediaries who often only pay a fraction of the price up front, and provide the remainder of the compensation after the product has been sold.

While such arrangements may effectively diffuse market risk, such an arrangement only makes sense under a system of cash accounting. Because under cash accounting, the farm operator is only responsible for paying taxes on the income he or she has received.

Should farmers lose the ability to use cash accounting, many would have to pay taxes on income they have yet to receive. In the asset-rich but cash-poor agriculture industry, this arrangement simply is not feasible.

The phrase "not feasible," isn't just rhetoric. After the House Ways and Means Committee and Senate Finance Committee floated the idea of forcing farms with more than $10 million in revenue to use accrual accounting instead of cash accounting, Kennedy and Coe commissioned Informa Economics to study the potential impacts of the policy change. As the study shows, the results would be catastrophic.

Informa Economics concluded that U.S. agricultural producers forced to switch from cash-basis to accrual-basis accounting under the draft tax bill would have to accelerate payment on as much as $4.84 billion in taxes over the next four years. Additionally, the borrowing capacity of these operations would decrease by another $7.26 billion over the same time period.

To put that $12.1 billion loss in working capital in context, Informa estimates that the combined liquid capital of impacted farms is only $1.8 billion. This means that losing cash accounting would likely force farmers and ranchers to either sell assets or go to the bank, just to pay their taxes, in many cases on products for which they have yet to receive payment.

The Informa study quantified what we'd heard from producers across the U.S.—losing cash accounting would have a major negative effect on American agriculture. Meeting the immediate tax burden is going to be very difficult or impossible for producers who simply do not have the cash flow to pay taxes before they sell their products.

Conclusion

I want to close by once again expressing my appreciation for the leadership of the many champions of small business and family farms on this Committee. The cash basis of accounting provides the lifeblood of rural America—our agriculture industry—with the ability to thrive even in today's challenging market environment.

Mr. Chairman, Madam Ranking Member, Members of the Committee, I am grateful for the opportunity to share the perspective of the agriculture community. I appreciate your efforts to call attention to the need to simplify and expand the use of cash accounting, and look forward to working with you to ensure that this expansion benefits our nation's farmers and ranchers.